Proposed Reorganized Standards

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

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Example of To Comment: Learn more on how to comment link

How to Comment on Board Rulemaking

PCAOB encourages all interested parties to comment on its proposed rules and standards.

TO SUBMIT A COMMENT

Comments must be in writing and may be submitted by:

E-Mail: comments@pcaobus.org
Comments may be included in the body of the e-mail, attached as a Microsoft® Word Document, or attached as an Adobe PDF.

Postal Mail: Public Company Accounting Oversight Board
Attention: Office of the Secretary
1666 K Street, NW
Washington, DC 20006-2803

DOCKET REFERENCE

Please note the docket number in the e-mail subject line or, if by postal mail, in a reference line at the beginning of your comments.

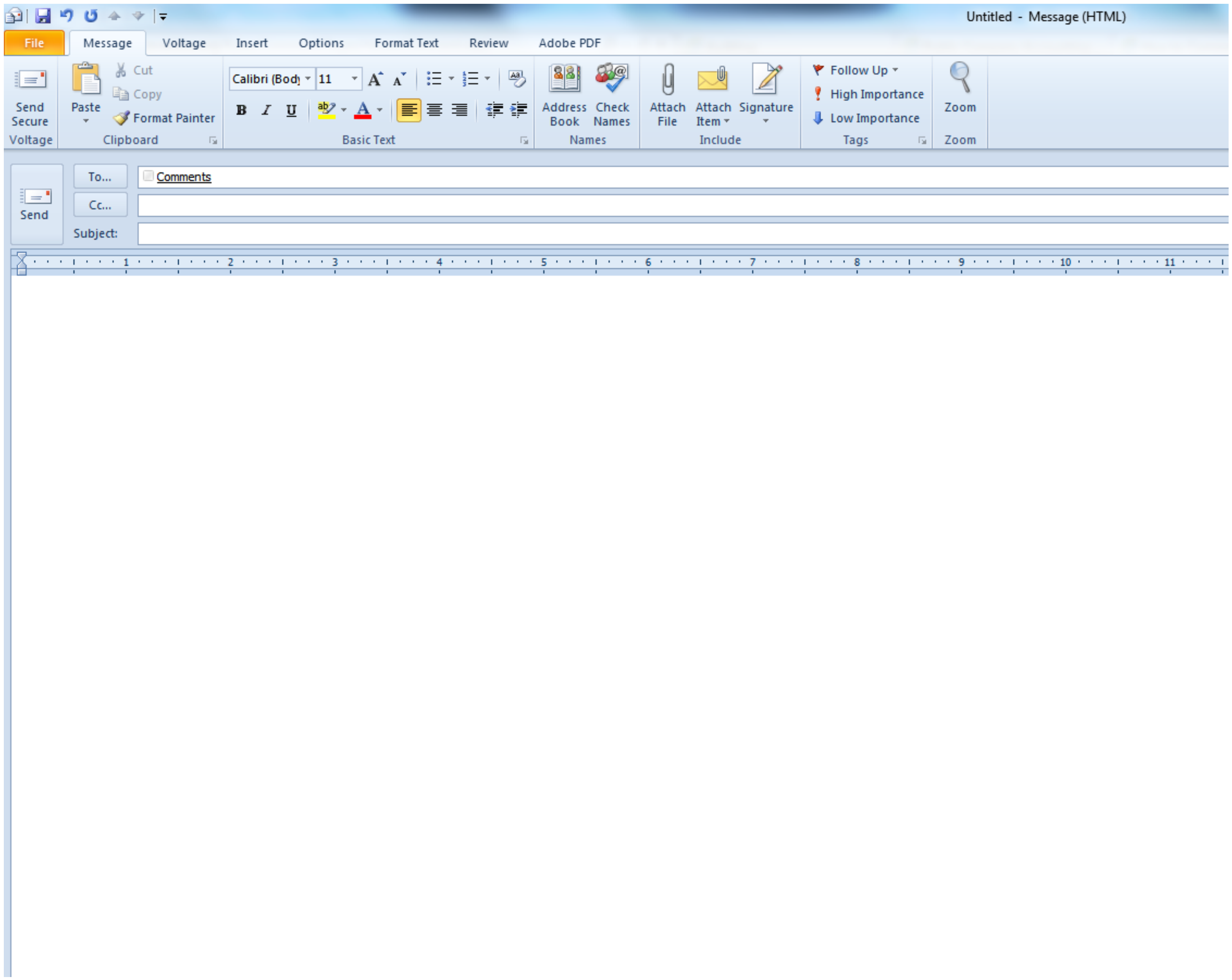
DISTRIBUTION

All comments are made public and posted on the PCAOB Web site. You are encouraged, but not required, to provide your name and professional affiliation.

OPEN FOR PUBLIC COMMENT

- All rulemaking dockets that are currently open for public comment

Example of To Comment: Submit a comment letter link



General Auditing Standards

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AS 1001: Responsibilities and Functions of the Independent Auditor

COMMENT ▼ TOOLS ▼

Issue date, unless otherwise indicated: November, 1972.

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.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 the standards of the PCAOB. 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.

Auditor Reporting

Matters Relating to Filings Under Federal Securities Laws

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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. fn 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. fn2 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 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 fn3 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 the standards of the PCAOB, 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 Statement on Auditing Standards Nos. 82 and 99. Paragraphs renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

Responsibility to the Profession

[.10] [Paragraph deleted.]

.11 The auditor should be aware of and consider auditing interpretations applicable to his or her audit. If the auditor does not apply the auditing guidance included in an applicable auditing interpretation, the auditor should be prepared to explain how he or she complied with the provisions of the auditing standard addressed by such auditing guidance.

> Note: The term "auditing interpretations," as used in this paragraph, refers to the publications entitled "Auditing Interpretation" issued by the American Institute of Certified Public Accountants' Auditing Standards Board as in existence on April 16, 2003, and in effect.

Footnotes (AS 1001 — Responsibilities and Functions of the Independent Auditor):

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

fn1 See AS 2105, *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 AS 2405, *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.

fn2 See paragraphs .10 through .13 of AS 1015, *Due Professional Care in the Performance of Work*. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

fn3 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.]

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AS 1005: Independence

COMMENT ▼ TOOLS ▼

Issue date, unless otherwise indicated: November, 1972.

.01 In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.

.02 The statement in the preceding paragraph 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.

.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.

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AS 1010: Training and Proficiency of the Independent Auditor

COMMENT ▼ TOOLS ▼

Issue date, unless otherwise indicated: November, 1972.

.01 The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.

.02 The statement in the preceding paragraph 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.03 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.]

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AS 1015: Due Professional Care in the Performance of Work [fn *]

COMMENT ▼ TOOLS ▼

Issue date, unless otherwise indicated: November, 1972.

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See Staff Audit Practice Alerts No. 9 and No. 10 for guidance on AS 1015.

.01 Due professional care is to be exercised in the planning and performance of the audit and the preparation of the report. **[fn1]**

[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 The statement in the preceding paragraph 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. **fn 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, 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.]

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.06 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. The engagement partner should know, at a minimum, the relevant professional accounting and auditing standards and should be knowledgeable about the client. **[fn 3]** The engagement partner is responsible for the assignment of tasks to, and supervision of, the members of the engagement team. **fn 4**

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

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.10 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.11 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. **fn 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. **[fn 6]**

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.12 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 the standards of the PCAOB rarely involves authentication of documentation, nor are auditors trained as or expected to be experts in such authentication. (See paragraph .09 of AS 1105, *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.

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.13 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).

Footnotes (AS 1015—Due Professional Care in the Performance of Work):

[fn *] [Footnote deleted.]

[fn 1] [Footnote deleted.]

fn 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.]

[fn 3] *[Footnote deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]*

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

fn 4 See AS 1201, *Supervision of the Audit Engagement*.

fn 5 See AS 2501, *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.]

[fn 6] *[Footnote deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]*

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AS 1101: Audit Risk

COMMENT ▼ TOOLS ▼

Effective Date: For audits of fiscal years beginning on or after Dec. 15, 2010

Final Rule: PCAOB Release No. 2010-004

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Introduction

.01 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

Federal Securities Laws

+ Other Matters Associated with Audits

.02 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

.03 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.

.04 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

.05 The risk of material misstatement refers to the risk that the financial statements are materially misstated. AS 2110, *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/

.06 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.

.07 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.

.08 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

.09 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/

Footnotes (AS 1101—Audit Risk):

1/ When the auditor is performing an integrated audit of financial statements and internal control over financial reporting, the requirements in AS 2201, *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 AS 2810, *Evaluating Audit Results*.

3/ See AS 1001, *Responsibilities and Functions of the Independent Auditor,* and paragraph .10 of AS 1015, *Due Professional Care in the Performance of Work,* for a further discussion of reasonable assurance.

4/ See AS 1105, *Audit Evidence,* for a description of financial statement assertions.

5/ AS 2110.59.

6/ AS 2110.59a.

7/ Paragraphs .32–.34 of AS 2301, *The Auditor's Responses to the Risks of Material Misstatement.*

8/ AS 2301.37.

[Effective pursuant to SEC Release No. 34-63606, File No. PCAOB-2010-01 (December 23, 2010)]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 1105: Audit Evidence

COMMENT ▼ TOOLS ▼

Effective Date: For audits of fiscal years beginning on or after Dec. 15, 2010

Final Rule: PCAOB Release No. 2010-004

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See Staff Audit Practice Alert No. 8 for guidance on AS 1105.

Introduction

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Other Matters Associated with Audits

.01 This standard explains what constitutes audit evidence and establishes requirements regarding designing and performing audit procedures to obtain sufficient appropriate audit evidence.

.02 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

.03 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

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

.05 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.

.06 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

.07 *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.

.08 *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.

.09 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.

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.

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.

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.

.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.

Footnotes (AS 1105—Audit Evidence):

1/ AS 2810, *Evaluating Audit Results,* establishes requirements regarding evaluating whether sufficient appropriate evidence has been obtained. AS 1215, *Audit Documentation,* establishes requirements regarding documenting the procedures performed, evidence obtained, and conclusions reached in an audit.

2/ Paragraph .A5 of AS 2110, *Identifying and Assessing Risks of Material Misstatement*.

3/ When using the work of a specialist engaged or employed by management, see AS 1210, *Using the Work of a Specialist.* When using information produced by a service organization or a service auditor's report as audit evidence, see AS 2601, *Consideration of an Entity's Use of a Service Organization*, and for integrated audits, see AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

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 AS 2201.28.

6/ AS 2110.

7/ AS 2301, *The Auditor's Responses to the Risks of Material Misstatement.*

8/ AS 2510, *Auditing Inventories,* establishes requirements regarding observation of the counting of inventory.

9/ AS 2805, *Management Representations*, establishes requirements regarding written management representations, including confirmation of management responses to oral inquiries.

10/AS 2310, *The Confirmation Process.*

11/AS 2305, *Substantive Analytical Procedures,* establishes requirements on performing analytical procedures as substantive procedures.

12/If misstatements are identified in the selected items, see AS 2810.12–.13 and AS 2810.17–.19.

13/AS 2315, *Audit Sampling,* establishes requirements regarding audit sampling.

[Effective pursuant to SEC Release No. 34-63606, File No. PCAOB-2010-01 (December 23, 2010)]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 1110: Relationship of Auditing Standards to Quality Control Standards

COMMENT ▼ TOOLS ▼

Issue date, unless otherwise indicated: November, 1979.

.01 The independent auditor is responsible for compliance with the standards of the PCAOB in an audit engagement.

.02 A firm of independent auditors has a responsibility to adopt a system of quality control in conducting an audit practice. **fn2** Thus, a firm should establish quality control policies and procedures to provide it with reasonable assurance that its personnel comply with the standards of the PCAOB 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 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, 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 the auditing standards. [As amended, effective September 2002, by Statement on

Federal Securities Laws

Other Matters Associated with Audits

Auditing Standards No. 98.]

Footnotes (AS 1110—Relationship of Auditing Standards to Quality Control Standards):

fn2 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.]

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1000 General Principles and Responsibilities

1100 General Concepts

1200 General Activities

AS 1201: Supervision of the Audit Engagement

AS 1205: Part of the Audit Performed by Other Independent Auditors

AS 1210: Using the Work of a Specialist

AS 1215: Audit Documentation

AS 1220: Engagement Quality Review

1300 Auditor

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AS 1201: Supervision of the Audit Engagement

COMMENT ▼ TOOLS ▼

Effective Date: For audits of fiscal years beginning on or after Dec. 15, 2010

Final Rule: PCAOB Release No. 2010-004

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See Staff Audit Practice Alerts No. 6, No. 8, and No. 10 for guidance on AS 1201.

Introduction

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

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Objective

.02 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

.03 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 .05–.06 of this standard describe the nature and extent of supervisory activities necessary for proper supervision of engagement team members. 6/

.04 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

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

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 AS 1015, 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/

.06 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

d. The knowledge, skill, and ability of each engagement team member. 12/

Note: In accordance with the requirements of AS 2301.05, the extent of supervision of engagement team members should be commensurate with the risks of material misstatement. 13/

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.

Footnotes (AS 1201—Supervision of the Audit Engagement):

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

2/ AS 1210, *Using the Work of a Specialist.*

3/ AS 1205, *Part of the Audit Performed by Other Independent Auditors.*

4/ AS 2605, *Consideration of the Internal Audit Function.*

5/ Paragraphs .16–.19 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.*

6/ See also paragraph .06 of AS 1015, *Due Professional Care in the Performance of Work.*

7/ AS 1015.06 and paragraph .05 of AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*, establish requirements regarding the appropriate assignment of engagement team members.

8/ AS 2110, *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 AS 2101, *Audit Planning*, AS 2110.74, and paragraphs .20–.23 and .35–.36 of AS 2810, *Evaluating Audit Results.*

10/ AS 2810 describes the auditor's responsibilities for evaluating the results of the audit, and AS 1215, *Audit Documentation,* establishes requirements regarding audit documentation.

11/ AS 2110.10.

12/ See also AS 2301.05a and AS 1015.06.

13/ AS 2301.05b indicates that the extent of supervision of engagement team members is part of the auditor's overall responses to the risks of material misstatement.

[Effective pursuant to SEC Release No. 34-63606, File No. PCAOB-2010-01 (December 23, 2010)]

General Auditing Standards

1000 General Principles and Responsibilities

1100 General Concepts

1200 General Activities

AS 1201: Supervision of the Audit Engagement

AS 1205: Part of the Audit Performed by Other Independent Auditors

AS 1210: Using the Work of a Specialist

AS 1215: Audit Documentation

AS 1220: Engagement Quality Review

1300 Auditor

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AS 1205: Part of the Audit Performed by Other Independent Auditors

COMMENT ▼ TOOLS ▼

Issue date, unless otherwise indicated: November, 1972.

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See Staff Audit Practice Alerts No. 6 and No. 8 for guidance on AS 1205.

.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. **fn 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 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

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 AS 2201, *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 No. 2010-004.]

Note: For situations in which the auditor engages an accounting firm or individual accountants to participate in the audit engagement and AS 1205 does not apply, the auditor should supervise them in accordance with the requirements of AS 1201, *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 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 **fn 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.

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. fn 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 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 audit and the report of the other auditors provide a reasonable basis for our opinion.
>
> 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, **fn 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 PCAOB and the requirements of the Securities and Exchange Commission (SEC). **[fn 4a]**

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 standards of the PCAOB 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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.12 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 AS 1205.10, 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 AS 1215, *Audit Documentation*.

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 AS 1215.08.

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. **fn 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 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: fn *

> 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; 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 AS 2610.)

Footnotes (AS 1205—Part of the Audit Performed by Other Independent Auditors):

fn 1 AS 2610, *Initial Audits—Communications Between Predecessor and Successor Auditors,* applies if an auditor uses the work of a predecessor auditor in expressing an opinion on financial statements.

fn 2 See paragraph .09 for example of appropriate reporting when reference is made to the audit of other auditors.

fn 3 As to filings with the Securities and Exchange Commission, see Rule 2-05 of Regulation S-X.

fn 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.]

[fn 4a] [Footnote deleted, December 2001, to acknowledge the dissolution of the Independence Standard Board.]

fn 5 As it relates to the direction in paragraph .19 of AS 2601, *Consideration of an Entity's Use of a Service Organization*, for the auditor to "give consideration to the guidance in AS 1205.12," the auditor need not, in this circumstance, obtain the previously enumerated documents.

fn * 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.

General Auditing Standards

1000 General Principles and Responsibilities

1100 General Concepts

1200 General Activities

AS 1201: Supervision of the Audit Engagement

AS 1205: Part of the Audit Performed by Other Independent Auditors

AS 1210: Using the Work of a Specialist

AS 1215: Audit Documentation

AS 1220: Engagement Quality Review

1300 Auditor

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 1210: Using the Work of a Specialist

COMMENT ▼ TOOLS ▼

Effective for audits of periods ending on or after December 15, 1994.

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See AI 11 for interpretations of AS 1210.

See Staff Audit Practice Alert No. 2 and Staff Questions and Answers on Auditing the Fair Value of Share Options Granted to Employees for guidance on AS 1210.

Communications

Audit Procedures

Auditor Reporting

Matters Relating to Filings Under Federal Securities Laws

Other Matters Associated with Audits

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 the standards of the PCAOB. 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. **fn 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 AS 2505, *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 **fn 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) **fn 3** and to engagements performed under AS 3305, *Special Reports*, including a comprehensive basis of accounting other than GAAP.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.05 This section does not apply to situations in which a specialist employed by the auditor's firm participates in the audit. AS 1201 applies in those situations.

Decision to Use the Work of a Specialist

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.06 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 **fn 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

.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 **fn 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 fn 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.

Effect of the Specialist's Work on the Auditor's Report

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.13 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 paragraphs .22 and .23 of AS 3101, *Reports on Audited Financial Statements*.)

.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 AS 3101.35, .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.

Footnotes (AS 1210—Using the Work of a Specialist):

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

fn 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. AS 1201, *Supervision of the Audit Engagement*, applies in those situations.

fn 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.

fn 3 References in this section to "financial statements" and to "generally accepted accounting principles" include special reports covered under AS 3305.

fn 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.

fn 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.

fn 6 The term *relationship* includes, but is not limited to, those situations discussed in footnote 1 of AS 2410, *Related Parties*.

General Auditing Standards

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AS 1210: Using the Work of a Specialist

AS 1215: Audit Documentation

AS 1220: Engagement Quality Review

1300 Auditor

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AS 1215: Audit Documentation

COMMENT ▼ TOOLS ▼

Effective Date: 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.

Final Rule: PCAOB Release No. 2004-006

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Introduction

.01 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

.02 *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.

.03 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.

[The following subparagraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

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

.04 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.

.05 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.

.06 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.

.07 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.

.08 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.

.09 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 AS 2901, *Consideration of Omitted Procedures After the Report Date*.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.]

.09A 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.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. 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), 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.

[The following note is effective for audits of fiscal years ending on or after June 1, 2014. See PCAOB Release No. 2013-007 .]

Note: In an engagement conducted pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, significant findings or issues include, when applicable: (a) the assessment of, and the responses to, risks requiring special consideration by the auditor; (b) significant matters involving systems, processes, and controls to ensure the appropriateness of the subject matter and management's related assertions; and (c) the evaluation of identified instances of nonconformity with the evaluation criteria (e.g., errors, instances of non-compliance, or control deficiencies).

.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.

[The following note is effective for audits of fiscal years ending on or after June 1, 2014. See PCAOB Release No. 2013-007.]

Note: When conducting an attestation engagement pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, the auditor may include the documentation of significant findings or issues related to the attestation engagement in the engagement completion document prepared in connection with the audit of the financial statements.

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 AS 4101, *Responsibilities Regarding 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 .04–.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/

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.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 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 .08.
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 AS 1205, *Part of the 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 deleted, effective for fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

Footnotes (AS 1215 — Audit Documentation):

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

[The following footnote is effective for audits of fiscal years ending on or after June 1, 2014. See PCAOB Release No. 2013-007. For audits of fiscal years ending before June 1, 2014, click here.]

2/ Relevant financial statement assertions are described in paragraphs .28–.33 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. In an engagement conducted pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, the relevant assertions are the assertions expressed by management or the responsible party regarding the subject matter of the attestation engagement. The documentation requirements in this standard regarding assertions apply to the aspects of the subject matter to which the assertions relate.

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.]

2A/ See paragraphs .12–.13 of AS 2110, *Identifying and Assessing Risks of Material Misstatement*, and paragraphs .66–.67 of AS 2401, *Consideration of Fraud in a Financial Statement Audit*.

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.]

2B/ See paragraphs .10–.23 of AS 2810, *Evaluating Audit Results*.

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.]

2C/ See AS 2110.74 and AS 2810.36.

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.

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 pursuant to SEC Release No. 34-50253, File No. PCAOB-2004-05 (August 25, 2004)]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 1220: Engagement Quality Review

COMMENT ▼ TOOLS ▼

Effective Date: For engagement quality reviews of audits and interim reviews for fiscal years beginning on or after December 15, 2009

Final Rule: PCAOB Release 2009-004

SUMMARY TABLE OF CONTENTS

See Staff Audit Practice Alerts No. 5 and No. 10 and Staff Questions and Answers on Auditing Standard No. 7, Engagement Quality Review, for guidance on AS 1220.

Applicability of Standard

[The following paragraph is effective for audits of fiscal years ending on or after June 1, 2014. See PCAOB Release No. 2013-007. For audits of fiscal years ending before June 1, 2014, click here.]

.01 An engagement quality review and concurring approval of issuance are required for the following engagements conducted pursuant to the standards of the Public Company Accounting Oversight Board ("PCAOB"): (a) an audit engagement; (b) a review interim financial information; and (c) an attestation engagement performed pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*.

Objective

.02 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

.03 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/

.04 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.

COMPETENCE

.05 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

.06 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.

.07 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.

.08 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

.09 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,

   - 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.

[The following note is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

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.

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 -
   - 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 .10d and .10e.
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 .10h and .10i

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.

[The following paragraph is effective for audits of fiscal years ending on or after June 1, 2014. See PCAOB Release No. 2013-007.]

Engagement Quality Review for an Attestation Engagement Performed Pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*

.18A In an attestation engagement performed pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, 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 attestation engagement and in preparing the engagement report. To evaluate such judgments and conclusions, the engagement quality reviewer should, taking into account the procedures performed in the engagement quality review of the financial statement audit, (1) hold discussions with the engagement partner and other members of the engagement team, (2) read the engagement report and the document containing management's assertions, and (3) review the engagement completion document and other relevant documentation.

[The following paragraph is effective for audits of fiscal years ending on or after June 1, 2014. See PCAOB Release No. 2013-007.]

.18B In an attestation engagement performed pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, 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 any significant engagement deficiency.

[The following note is effective for audits of fiscal years ending on or after June 1, 2014. See PCAOB Release No. 2013-007.]

> Note: A *significant engagement deficiency* in an attestation engagement performed pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, exists when (1) the engagement team failed to perform attestation 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.

[The following paragraph is effective for audits of fiscal years ending on or after June 1, 2014. See PCAOB Release No. 2013-007.]

.18C In an attestation engagement performed pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, the firm may grant permission to the client to use the engagement report 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 AS 1215 apply with respect to the documentation of the engagement quality review.

Footnotes (AS 1220 — Engagement Quality Review):

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 AS 4105, *Reviews of 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.

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

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.

4/ Paragraph .13 of AS 1215, *Audit Documentation,* requires the auditor to identify all significant findings or issues in an engagement completion document.

5/ See paragraphs .04–.06 of AS 2710, *Other Information in Documents Containing Audited Financial Statements*; AS 4101, *Responsibilities Regarding Filings Under Federal Securities Statutes*.

6/ See AS 1015, *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.

8/ See AS 4105.18f; AS 4101.

[Effective pursuant to SEC Release No. 34-61363, File No. PCAOB-2009-02 (January 15, 2010)]

Find an Auditing Standard Before the Reorganization

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

Select a reorganized auditing standard to find the corresponding auditing standard before the reorganization.

SELECT A PCAOB STANDARD AFTER REORGANIZATION

MATCHING STANDARDS

There are no matching standards.

REFERENCE TOOLS

- Reorganized to Pre-reorganized
- Pre-reorganized to Reorganized
- PCAOB to IAASB and ASB

GUIDANCE TOOLS

- Auditing Interpretations
- Staff Practice Alerts
- Staff Questions and Answers

TO COMMENT

- Learn more on how to comment
- Submit a comment letter

Example of Reference Tools: Reorganized to Pre-reorganized

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SELECT A PCAOB STANDARD AFTER REORGANIZATION

AS 1220: Engagement Quality Review

CORRESPONDING STANDARDS

AFTER REORGANIZATION	BEFORE REORGANIZATION
AS 1220: Engagement Quality Review	AS No. 7: Engagement Quality Review

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Find an Auditing Standard After the Reorganization

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Select an auditing standard before the reorganization to find the corresponding reorganized auditing standard.

SELECT A PCAOB STANDARD BEFORE REORGANIZATION

MATCHING STANDARDS

There are no matching standards.

REFERENCE TOOLS

- Reorganized to Pre-reorganized
- Pre-reorganized to Reorganized
- PCAOB to IAASB and ASB

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Example of Reference Tools: Pre-reorganized to Reorganized

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

Select an auditing standard before the reorganization to find the corresponding reorganized auditing standard.

SELECT A PCAOB STANDARD BEFORE REORGANIZATION

AU sec. 508: Reports on Audited Financial Statements

CORRESPONDING STANDARDS

BEFORE REORGANIZATION	AFTER REORGANIZATION
AU sec. 508: Reports on Audited Financial Statements	AS 3101: Reports on Audited Financial Statements

Find an Analogous Standard

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

Find PCAOB auditing standards by the analogous standards of the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board of the American Institute of Certified Public Accountants ("ASB").

SELECT A PCAOB STANDARD

SELECT AN ASB STANDARD

SELECT AN IAASB STANDARD

MATCHING STANDARDS

There are no matching standards.

REFERENCE TOOLS

- Reorganized to Pre-reorganized
- Pre-reorganized to Reorganized
- PCAOB to IAASB and ASB

GUIDANCE TOOLS

- Auditing Interpretations
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TO COMMENT

- Learn more on how to comment
- Submit a comment letter

Example of Reference Tools: PCAOB to IAASB and ASB

Find an Analogous Standard

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

Find PCAOB auditing standards by 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.

SELECT A PCAOB STANDARD

AS 1215: Audit Documentation

SELECT AN ASB STANDARD

SELECT AN IAASB STANDARD

ANALOGOUS STANDARDS

PCAOB STANDARD	ASB STANDARD	IAASB STANDARD
AS 1215: Audit Documentation	AU-C 230	ISA 230

Guidance

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AUDITING INTERPRETATIONS

Auditing Interpretations are publications issued by the American Institute of Certified Public Accountant's Auditing Standards Board as in existence on April 16, 2003, to the extent not superseded or amended by the Board. The auditor should be aware of and consider auditing interpretations applicable to his or her audit. If the auditor does not apply the auditing guidance included in an applicable auditing interpretation, the auditor should be prepared to explain how he or she complied with the provisions of the auditing standard addressed by such auditing guidance.

- AI 10 - Part of the Audit Performed by Other Independent Auditors: Auditing Interpretations of AS 1205
- AI 11 - Using the Work of a Specialist: Auditing Interpretations of AS 1210
- AI 12 - Communications About Control Deficiencies in an Audit of Financial Statements: Auditing Interpretations of AS 1305
- AI 13 - Illegal Acts by Clients: Auditing Interpretations of AS 2405
- AI 14 - Related Parties: Auditing Interpretations of AS 2410
- AI 15 - Consideration of an Entity's Ability to Continue as a Going Concern: Auditing Interpretations of AS 2415
- AI 16 - Auditing Accounting Estimates: Auditing Interpretations of AS 2501
- AI 17 - Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of AS 2505
- AI 18 - Consideration of an Entity's Use of a Service Organization: Auditing Interpretations of AS 2601

View all proposed reorganized standards

REFERENCE TOOLS

- Reorganized to Pre-reorganized
- Pre-reorganized to Reorganized
- PCAOB to IAASB and ASB

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TO COMMENT

- Learn more on how to comment
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- AI 19 - Unaudited Supplementary Information Included in Audited Financial Statements: Auditing Interpretations of AS 2705
- AI 20 - Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of AS 2710
- AI 21 - Management Representations: Auditing Interpretations of AS 2805
- AI 22 - Subsequent Discovery of Facts Existing at the Date of the Auditor's Report: Auditing Interpretations of AS 2905
- AI 23 - Reports on Audited Financial Statements: Auditing Interpretations of AS 3101
- AI 24 - Special Reports: Auditing Interpretations of AS 3305
- AI 25 - Association with Financial Statements: Auditing Interpretations of AS 3320
- AI 26 - Responsibilities Regarding Filings Under Federal Securities Statutes: Auditing Interpretations of AS 4101
- AI 27 - Letters for Underwriters and Certain Other Requesting Parties: Auditing Interpretations of AS 6101
- AI 28 - Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations

STAFF AUDIT PRACTICE ALERTS

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. 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.

- Alert No. 11: Considerations for Audits of Internal Control Over Financial Reporting (Oct. 24, 2013)
- Alert No. 10: Maintaining and Applying Professional Skepticism in Audits (Dec. 4, 2012)
- Alert No. 9: Assessing and Responding to Risk in the Current Economic Environment (Dec. 6, 2011)
- Alert No. 8: Audit Risks in Certain Emerging Markets (Oct. 3, 2011)
- Alert No. 7: Auditor Considerations of Litigation and Other Contingencies Arising from Mortgage and Other Loan Activities (Dec. 20, 2010)
- Alert No. 6: Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants from Outside the Firm (July 12, 2010)
- Alert No. 5: Auditor Considerations Regarding Significant Unusual Transactions (April 7, 2010)
- Alert No. 4: Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments (April 21, 2009)
- Alert No. 3: Audit Considerations in the Current Economic Environment (Dec. 5, 2008)
- Alert No. 2: Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists (Dec. 10, 2007)
- Alert No. 1: Matters Related to Timing and Accounting for Option Grants (July 28, 2006)

STAFF QUESTIONS AND ANSWERS

Staff questions and answers set forth the staff's opinions on issues related to the implementation of the standards of the PCAOB. The PCAOB 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.

- Auditing Standard No. 7, Engagement Quality Review (Feb. 19, 2010)
- References to Authoritative Accounting Guidance in PCAOB Standards (Sept. 2, 2009)
- Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees (April 3, 2007)
- Auditing the Fair Value of Share Options Granted to Employees (Oct.17, 2006)
- Adjustments to Prior-Period Financial Statements Audited by a Predecessor Auditor (June 9, 2006)
- Attest Engagements Regarding XBRL Financial Information Furnished Under the XBRL Voluntary Financial Reporting Program on the EDGAR System (May 25, 2005)
- Audits of Financial Statements of Non-Issuers Performed Pursuant to the Standards of the Public Company Accounting Oversight Board (June 30, 2004)

OTHER STAFF GUIDANCE

Staff guidance sets forth the staff's views on issues related to the implementation of the standards of the PCAOB. The statements contained in staff guidance are not rules of the Board, nor have they been approved by the Board.

- 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 (Jan. 23, 2009)
  - Preliminary Staff Views – An Audit of Internal Control That Is Integrated with An Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies (Oct. 17, 2007)
  - Preliminary Staff Views – Comment letters

OTHER BOARD RELEASES

Board releases regarding implementation of standards of the PCAOB are issued periodically.

- Policy Statement Regarding Implementation of Auditing Standard No. 2: An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements (May 16, 2005)

General Auditing Standards
1000 General Principles and Responsibilities
1100 General Concepts
1200 General Activities
1300 Auditor Communications
AS 1301: Communications with Audit Committees
AS 1305: Communications About Control Deficiencies in an Audit of Financial Statements
Audit Procedures
Auditor Reporting
Matters Relating to Filings Under Federal Securities

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 1301: Communications with Audit Committees

COMMENT ▼ TOOLS ▼

Effective Date: For audits of fiscal years beginning on or after Dec. 15, 2012

Final Rule: PCAOB Release No. 2012-004

SUMMARY TABLE OF CONTENTS

Introduction

.01 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.

.02 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

.03 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

.04 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

.05 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.

.06 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.

.07 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

.08 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

.09 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/

.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/

(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/

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/

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/

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 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 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.

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.

- AS 6115, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist,* paragraphs .60, .62, and .64
- AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* paragraphs .78–.81, .91, .C7, and .C14
- AS 2110, *Identifying and Assessing Risks of Material Misstatement,* paragraphs .05f and .54–.57

[The following two bullets are effective for audits of fiscal years ending on or after June 1, 2014. See PCAOB Release No. 2013-007. For audits of fiscal years ending before June 1, 2014, click here.]

- Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, paragraphs 34 and 35
- Attestation Standard No. 2, *Review Engagement Regarding Exemption Reports of Brokers and Dealers*, paragraph 15
- 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*
- AS 2401, *Consideration of Fraud in a Financial Statement Audit,* paragraphs .79–.81
- AS 2405, *Illegal Acts by Clients,* paragraphs .08, .17, and .20
- AS 1305, *Communications About Control Deficiencies in an Audit of Financial Statements,* paragraphs .04–.07 and .09
- AS 2502, *Auditing Fair Value Measurements and Disclosures,* paragraph .50
- AS 2805, *Management Representations*, paragraph .05
- AS 2710, *Other Information in Documents Containing Audited Financial Statements*, paragraphs .04 and .06
- AS 4101, *Responsibilities Regarding Filings Under Federal Securities Statutes*, paragraph .13
- AS 4105, *Reviews of 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. 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 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/

Footnotes (AS 1301—Communications with Audit Committees):

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.

See e.g ,

3/ . 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.

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 .05f and .54–.57 of AS 2110, *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* AS 2405, *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 .08–.09 of AS 2101, *Audit Planning,* for a description of the auditor's responsibilities for establishing an overall audit strategy.

8/ AS 2110 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 AS 2101 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* AS 2605, *Consideration of the Internal Audit Function,* which describes the auditor's responsibilities related to the work of internal auditors.

11/ *See* paragraphs .16–.19 of AS 2201, *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* AS 2101.08–.14, 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* AS 1205, *Part of the 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* AS 2101.15, 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* AS 2501, *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.*

19/ *Id.*

20/ *See* AS 2110.71g.

21/ *See* paragraphs .24–.27 of AS 2810, *Evaluating Audit Results*, which describe the auditor's responsibilities related to evaluating the qualitative aspects of the company's accounting practices.

22/ *See* AS 2810.27.

23/ *See* AS 2501, 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 AS 2401, *Consideration of Fraud in a Financial Statement Audit*.

25/ *See* AS 2810.30–.31, 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 AS 2410, *Related Parties,* and AS 2415, *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).

[The following footnote is effective for audits of fiscal years ending on or after June 1, 2014. See PCAOB Release No. 2013-008. For audits of fiscal years ending before June 1, 2014, click here.]

27/ *See*, *e.g.*, AS 2710, *Other Information in Documents Containing Audited Financial Statements*. In addition to AS 2710, discussion of the auditor's consideration of other information is included in AS 2701, *Auditing Supplemental Information Accompanying Audited Financial Statements,* AS 2705, *Unaudited Supplementary Information Included in Audited Financial Statements*, and AS 4101, *Responsibilities Regarding Filings Under Federal Securities Statutes*.

28/ *See* AS 2415 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, AS 2415.03a–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* AS 2415.06, which provides examples of such conditions and events and AS 2415.07, 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* AS 2415.08, which discusses the auditor's responsibilities related to the auditor's evaluation of management's plans.

31/ *See* AS 2415.12, which describes the effects on the auditor's report. *See also* AS 2415.03c, 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* AS 2415.10, which discusses the possible effects on the financial statements and the adequacy of the related disclosure.

33/ *See* AS 2415.12–.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.

34/ Footnote 13 to paragraph .20 of AS 2810 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 AS 2810 discusses the qualitative factors related to the evaluation of the materiality of uncorrected misstatements.

37/ *See* AS 2810.10, 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).

39/ *See* paragraphs .22–.32 of AS 3101, *Reports on Audited Financial Statements,* for a discussion of scope limitations.

40/ AS 2401.79–.81 and AS 2405.17 include specific communication requirements relating to fraud or illegal acts, respectively.

[41/] [Footnote deleted.]

42/ Consistent with the requirements of AS 1215, *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.

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.

Footnotes (Appendix C—Matters Included in the Audit Engagement Letter):

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.

2/ AS 1305, *Communications About Control Deficiencies in an Audit of Financial Statements*, provides direction on control deficiencies identified in an audit of financial statements.

3/ Paragraphs .08–.09 of AS 4105, *Reviews of 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.

General Auditing Standards

1000 General Principles and Responsibilities

1100 General Concepts

1200 General Activities

1300 Auditor Communications

AS 1301: Communications with Audit Committees

AS 1305: Communications About Control Deficiencies in an Audit of Financial Statements

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In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 1305: Communications About Control Deficiencies in an Audit of Financial Statements

COMMENT ▼ TOOLS ▼

[The following is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

See AI 12 for interpretations of AS 1305.

Note: For an integrated audit of financial statements and internal control over financial reporting, see paragraphs .78–.84 of AS 2201, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements

Note: The following paragraphs apply in an audit of financial statements only:

.01 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.

Laws

+ Other Matters Associated with Audits

- 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 qualifications to perform the control effectively.

.02 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.

.03 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 AS 2201.62–.70.

.04 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 .02 and .03.

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. **fn 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 **fn 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). **fn 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). **fn 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 **fn 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.

.05 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.

.06 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.

.07 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.

.08 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.

.09 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 AS 1305, "Reporting on the Existence of Material Weaknesses," continues to apply except that the term "reportable condition" means "significant deficiency," as defined in paragraph .02 of this standard.

Footnotes (AS 1305—Communications About Control Deficiencies in an Audit of Financial Statements):

fn 1 See 15 U.S.C. 78c(a)58 and 15 U.S.C. 7201(a)(3).

fn 2 See 17 C.F.R. 240.10A-3.

fn 3 See 17 C.F.R. 240.10A-3(c)(2).

fn 4 See 17 C.F.R. 240.10A-3(c)(2).

fn 5 See 17 C.F.R. 210-2-01(c)(7).

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AS 2101: Audit Planning

AS 2105: Consideration of Materiality in Planning and Performing an Audit

AS 2110: Identifying and Assessing Risks of Material Misstatement

2200 Auditing Internal Control Over Financial Reporting

2300 Audit Procedures in Response to Risks-Nature, Timing, and Extent

2400 Audit

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 2101: Audit Planning

COMMENT ▼ TOOLS ▼

Effective Date: For audits of fiscal years beginning on or after Dec. 15, 2010

Final Rule: PCAOB Release No. 2010-004

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See Staff Audit Practice Alerts No. 7, No. 9, and No. 10 for guidance on AS 2101.

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2800 Concluding Audit Procedures

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Other Matters Associated with Audits

.01 This standard establishes requirements regarding planning an audit.

Objective

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

Responsibility of the Engagement Partner for Planning

.03 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

.04 The auditor should properly plan the audit. This standard describes the auditor's responsibilities for properly planning the audit. 2/

.05 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

.06 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.

[The following subparagraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004. For audits of fiscal years beginning before December 15, 2012, click here.]

c. Establish an understanding of the terms of the audit engagement with the audit committee in accordance with AS 1301, *Communications with Audit Committees*.[4/]

PLANNING ACTIVITIES

.07 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 .08–.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 in the day-to-day activities of the business; and fewer levels of management, each with a wide span of control.

AUDIT STRATEGY

.08 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.

.09 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 .07 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 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 AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* 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 AS 2605, *Consideration of the Internal Audit Function*, or others, as described in AS 2201. AS 2605 and AS 2201 establish requirements regarding using the work of internal audit and others, respectively.

.14 AS 1205, *Part of the 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 AS 2610, *Initial Audits—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/

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.

Footnotes (AS 2101—Audit Planning):

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.* AS 1110, *Relationship of Auditing Standards to Quality Control Standards,* explains how the quality control standards relate to the conduct of audits.

[4/] [Footnote deleted, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004. For audits of fiscal years beginning before December 15, 2012, click here.]

5/ AS 2105, *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 following footnote is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004. For audits of fiscal years beginning before December 15, 2012, click here.]

7/ See, e.g., AS 1301. 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 .06 of AS 1201, *Supervision of the Audit Engagement*.

9/ Paragraph .06 of this standard.

10/ See, e.g., paragraph .06 of AS 1015, *Due Professional Care in the Performance of Work,* paragraph .16 of this standard, and paragraph .05a. of AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*.

11/ AS 2110, *Identifying and Assessing Risks of Material Misstatement*.

12/ AS 2301 and AS 2201.

13/ The term "business units" includes subsidiaries, divisions, branches, components, or investments.

14/ Paragraph .66 of AS 2401, *Consideration of Fraud in a Financial Statement Audit.*

15/ AS 2105.10 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/ AS 2201.B10–.B16.

18/ For integrated audits, see also AS 2201.C8–.C11.

19/ See also paragraph .03 of AS 2820, *Evaluating Consistency of Financial Statements.*

[Effective pursuant to SEC Release No. 34-63606, File No. PCAOB-2010-01 (December 23, 2010)]

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AS 2101: Audit Planning

AS 2105: Consideration of Materiality in Planning and Performing an Audit

AS 2110: Identifying and Assessing Risks of Material Misstatement

2200 Auditing Internal Control Over Financial Reporting

2300 Audit Procedures in Response to Risks-Nature, Timing, and Extent

2400 Audit

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AS 2105: Consideration of Materiality in Planning and Performing an Audit

COMMENT ▼ TOOLS ▼

Effective Date: For audits of fiscal years beginning on or after Dec. 15, 2010

Final Rule: PCAOB Release No. 2010-004

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See Staff Audit Practice Alert No. 9 for guidance on AS 2105.

Introduction

.01 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

.02 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/

.03 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 AS 2810, *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.

.04 For integrated audits, AS 2201, *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

.05 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

.06 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

.07 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

.08 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.

.09 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 AS 2810. 6/

Footnotes (AS 2105—Consideration of Materiality in Planning and Performing an Audit):

1/ AS 2810 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 AS 2810.

5/ AS 2201.20.

6/ AS 2810.17.

[Effective pursuant to SEC Release No. 34-63606, File No. PCAOB-2010-01 (December 23, 2010)]

General Auditing Standards

Audit Procedures

2100 Audit Planning and Risk Assessment

AS 2101: Audit Planning

AS 2105: Consideration of Materiality in Planning and Performing an Audit

AS 2110: Identifying and Assessing Risks of Material Misstatement

2200 Auditing Internal Control Over Financial Reporting

2300 Audit Procedures in Response to Risks-Nature, Timing, and Extent

2400 Audit

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 2110: Identifying and Assessing Risks of Material Misstatement

COMMENT ▼ TOOLS ▼

Effective Date: For audits of fiscal years beginning on or after Dec. 15, 2010

Final Rule: PCAOB Release No. 2010-004

SUMMARY TABLE OF CONTENTS

See Staff Audit Practice Alerts No. 7, No. 8, No. 9, No. 10, and No. 11 for guidance on AS 2110.

Introduction

.01 This standard establishes requirements regarding the process of identifying and assessing risks of material misstatement 1/ of the financial statements.

.02 Paragraphs .04–.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

.03 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

.04 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/

.05 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 .07–.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/

.06 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

.07 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.

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

INDUSTRY, REGULATORY, AND OTHER EXTERNAL FACTORS

.09 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 AS 2410, *Related Parties.*

.11 As part of obtaining an understanding of the company as required by paragraph .07, the auditor should consider performing the following procedures and the extent to which the procedures should be performed:

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

SELECTION AND APPLICATION OF ACCOUNTING PRINCIPLES, INCLUDING RELATED DISCLOSURES

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

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

- Significant changes in the company's accounting principles, financial reporting policies, or disclosures and the reasons for such changes;
- The financial reporting competencies of personnel involved in selecting and applying significant new or complex accounting principles;
- The accounts or disclosures for which judgment is used in the application of significant accounting principles, especially in determining management's estimates and assumptions;
- The effect of significant accounting principles in controversial or emerging areas for which there is a lack of authoritative guidance or consensus;
- The methods the company uses to account for significant and unusual transactions; and
- Financial reporting standards and laws and regulations that are new to the company, including when and how the company will adopt such requirements.

COMPANY OBJECTIVES, STRATEGIES, AND RELATED BUSINESS RISKS

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

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

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

- Industry developments (a potential related business risk might be, e.g., that the company does not have the personnel or expertise to deal with the changes in the industry.)
- New products and services (a potential related business risk might be, e.g., that the new product or service will not be successful.)
- Use of information technology ("IT") (a potential related business risk might be, e.g., that systems and processes are incompatible.)
- New accounting requirements (a potential related business risk might be, e.g., incomplete or improper

implementation of a new accounting requirement.)

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

  Note: Business risks could affect risks of material misstatement at the financial statement level, which would affect many accounts and disclosures in the financial statements. For example, a company's loss of financing or declining conditions affecting the company's 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 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, AS 2201, 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
- 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, AS 2201 [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.

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 .28e, 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 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, AS 2201 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. AS 2201 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 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.* AS 2201 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 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 .08 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 AS 4105, *Reviews of 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 AS 4105, 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.

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 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 AS 2401;[30/]
- The need to be alert for information or other conditions (such as those matters presented in Appendix C of AS 2810) 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.

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 .04–.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 .59e, the auditor should evaluate the qualitative and quantitative risk factors related to the financial statement line items and disclosures. Risk factors relevant to the identification of significant accounts and disclosures and their relevant assertions include:

- Size and composition of the account;
- Susceptibility to misstatement due to error or fraud;
- Volume of activity, complexity, and homogeneity of the individual transactions processed through the account or reflected in the disclosure;
- Nature of the account or disclosure;
- Accounting and reporting complexities associated with the account or disclosure;
- 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 AS 2401.85. 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 AS 2401.85 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/

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

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

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

Footnotes (AS 2110—Identifying and Assessing Risks of Material Misstatement):

1/ Paragraphs .05–.08 of AS 1101, *Audit Risk*.

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

3/ AS 2401, *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/ AS 1105, *Audit Evidence*, describes further audit procedures as consisting of tests of controls and substantive procedures.

5/ AS 1105.11 discusses financial statement assertions.

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/ AS 2405, *Illegal Acts by Clients*, discusses the auditor's consideration of laws and regulations relevant to the audit.

8/ Paragraphs .21–.22 of this standard discuss components of internal control over financial reporting.

9/ Paragraph .13 of AS 2201, *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/ AS 1105.10.

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

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

13/ AS 2201.05.

14/ AS 2201.25.

15/ AS 2201.A3.

16/ Examples of such events and conditions include depreciation and amortization and conditions affecting the recoverability of assets.

17/ Paragraphs .12–.13 of this standard.

18/ <u>Also see</u> 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. AS 2605, *Consideration of the Internal Audit Function*, establishes requirements regarding the auditor's consideration and use of the work of the internal audit function.

20/ See AS 2201.34–.38.

21/ Paragraphs .16–.35 of AS 2301, *The Auditor's Responses to the Risks of Material Misstatement.*

22/ AS 2201.B1.

23/ AS 2201.22.

24/ The entity-level controls included in AS 2201.24 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.

25/ See PCAOB Rule 3501(a)(i), which defines "affiliate of the accounting firm."

26/ Paragraph .07 of AS 2101, *Audit Planning.*

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

28/ Paragraphs .52–.53 of this standard.

29/ See also paragraph .29 of AS 2810, *Evaluating Audit Results*.

30/ AS 2401.13.

31/ AS 2810.20–.23 establish further requirements for evaluating whether misstatements might be indicative of fraud and determining the necessary procedures to be performed in those situations.

32/ AS 2301.16–.35.

33/ AS 2201.A10 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/ AS 2201.A9 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.

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 AS 2810.11, .14, and .25, for further discussion about undetected misstatement. See AS 2201.61 and AS 2301.5c, for further discussion about the unpredictability of auditing procedures.

36/ AS 2301 discusses the auditor's response to fraud risks and other significant risks.

37/ AS 2401.88 and AS 2201.14 present examples of controls that address fraud risks.

38/ See also AS 2301.46.

Footnotes (Appendix B—Consideration of Manual and Automated Systems and Controls):

1/ See also AS 2601, *Consideration of an Entity's Use of a Service Organization,* 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 AS 2101, *Audit Planning*.

[Effective pursuant to SEC Release No. 34-63606, File No. PCAOB-2010-01 (December 23, 2010)]

General Auditing Standards

Audit Procedures

2100 Audit Planning and Risk Assessment

2200 Auditing Internal Control Over Financial Reporting

AS 2201: An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements

2300 Audit Procedures in Response to Risks-Nature, Timing, and Extent

2400 Audit Procedures for Specific Aspects of the Audit

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 2201: An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements

COMMENT ▼ TOOLS ▼

Effective Date: Fiscal years ending on or after November 15, 2007

Final Rule: PCAOB Release No. 2007-005A

SUMMARY TABLE OF CONTENTS

See Staff Audit Practice Alerts No. 3, No. 5, No. 7, No. 9, and No. 11 and Staff Views on An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements: Guidance for Auditors of Small Public Companies for guidance on AS 2201.

Introduction

.01 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/

.02 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 weaknesses** exist, the company's internal control over financial reporting cannot be considered effective. 4/

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.03 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.

.04 The standards, [6/] AS 1005, *Independence*, AS 1010, *Training and Proficiency of the Independent Auditor*, and AS 1015, *Due Professional Care in the Performance of Work*, 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.

.05 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

.06 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.

.07 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.

.08 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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.09 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 -

- 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, 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.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 AS 2110.65–.69.

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. AS 2605, *Consideration of the Internal Audit Function,* 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 AS 2605.09 through .11 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 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;
- 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
- 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 AS 2605.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.36 The auditor also should understand how IT affects the company's flow of transactions. The auditor should apply paragraph .29 and Appendix B of AS 2110, 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.51 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 through .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.

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 through .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;

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 AS 2805, *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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004. For audits of fiscal years beginning before December 15, 2012, click here.]

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. 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004. For audits of fiscal years beginning before December 15, 2012, click here.]

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. 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 AS 2401, *Consideration of Fraud in a Financial Statement Audit*, AS 2405, *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 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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.89 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 through .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 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 .75h.

.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 through .09 of AS 2801, *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 AS 2905, *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/

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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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 through .32 of AS 4105, *Reviews of 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 AS 2601, *Consideration of an Entity's Use of a Service Organization*, 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 AS 2601 to the audit of internal control over financial reporting.

.B18 AS 2601.03 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 AS 2601.07 through .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 AS 2601.12. 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 AS 2601.24*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 AS 2601.24*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 AS 2601, 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 AS 2601.16.

.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 .10a of AS 1205, *Part of the 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

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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 No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

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. AS 1205, *Part of the 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 AS 1205.

.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 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. AS 2405, *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 AS 4105, *Reviews of 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 AS 4105, 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 AS 4101, *Responsibilities Regarding 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 AS 4101 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 AS 4101.10 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.

Footnotes (AS 2201—An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements):

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 AS 1015, *Due Professional Care in the Performance of Work*, for further discussion of the concept of reasonable assurance in an audit.

[6/] [Footnote deleted.]

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).

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).

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).

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

10/ See AS 2110, *Identifying and Assessing Risks of Material Misstatement,* regarding identifying risks that may result in material misstatement due to fraud.

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

11/ See AS 2105, *Consideration of Materiality in Planning and Performing an Audit*, which provides additional explanation of materiality.

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

12/ See AS 1105, *Audit Evidence*, which provides additional information on financial statement assertions.

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

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 AS 2810, *Evaluating Audit Results*, for further discussion about undetected misstatement) or as a means of introducing unpredictability in the procedures performed (see paragraph .61 and paragraph .05 of AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*, for further discussion about predictability of auditing procedures).

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.

16/ See Item 308(a) of Regulations S-B and S-K, 17 C.F.R. §§ 228.308(a) and 229.308(a).

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.

19/ See paragraph .C3 for direction when the scope of the engagement has been limited.

Footnotes (Appendix A—Definitions):

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).

2/ See 17 C.F.R. §§ 228.308(a)(3) and 229.308(a)(3).

3/ See FAS 5, paragraph 3.

Footnotes (Appendix C—Special Reporting Situations):

1/ See paragraph .B15, for further discussion of the evaluation of the controls over financial reporting for an equity method investment.

2/ See 15 U.S.C. § 78j-1.

3/ See 17 C.F.R. §§ 240.13a-14(a) and 240.15d-14(a).

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

General Auditing Standards

Audit Procedures

2100 Audit Planning and Risk Assessment

2200 Auditing Internal Control Over Financial Reporting

2300 Audit Procedures in Response to Risks-Nature, Timing, and Extent

AS 2301: The Auditor's Responses to the Risks of Material Misstatement

AS 2305: Substantive Analytical Procedures

AS 2310: The Confirmation Process

AS 2315: Audit Sampling

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 2301: The Auditor's Responses to the Risks of Material Misstatement

COMMENT ▼ TOOLS ▼

Effective Date: For audits of fiscal years beginning on or after Dec. 15, 2010

Final Rule: PCAOB Release No. 2010-004

SUMMARY TABLE OF CONTENTS

See Staff Audit Practice Alerts No. 7, No. 8, No. 9, and No. 10 for guidance on AS 2301.

Introduction

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

Objective

.02 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

.03 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 AS 2110, *Identifying and Assessing Risks of Material Misstatement.*

.04 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 .05–.07; and

b. Responses involving the nature, timing, and extent of the audit procedures to be performed, as described in paragraphs .08–.46.

Overall Responses

.05 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 .05–.06 of AS 1201, *Supervision of the Audit Engagement*.)

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

(1) Performing audit procedures related to accounts, disclosures, and assertions that would not otherwise be

tested based on their amount or the auditor's assessment of risk;

(2) Varying the timing of the audit procedures;

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

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

(5) In multi-location audits, varying the location or the nature, timing, and extent of audit procedures at related locations or business units from year to year. 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 deleted; effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004. For audits of fiscal years beginning before December 15, 2012, click here.]

.06 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.

.07 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 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

.08 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.

.09 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: AS 2201 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.

Note: AS 2110 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: AS 2201 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: AS 2401.54–.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, AS 2401 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 (AS 2401.58–.62);
b. Reviewing accounting estimates for biases that could result in material misstatement due to fraud (AS 2401.63–.65); and
c. Evaluating the business rationale for significant unusual transactions (AS 2401.66–.67).

Testing Controls

TESTING CONTROLS IN AN AUDIT OF FINANCIAL STATEMENTS

.16 *Controls to be Tested.* If the auditor plans to assess control risk at less than the maximum by relying on controls, [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 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.

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: AS 2315, *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;
- 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: AS 2201 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. AS 1305, *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 AS 2201 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/ AS 2201 establishes requirements regarding the selection of controls to be tested and the necessary nature, timing, and extent of tests of controls in an audit of internal control over financial reporting.

Substantive Procedures

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

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

.38 Internal control over financial reporting has inherent limitations,[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: AS 1105 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 .09b, 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: AS 2401.58–.62 establish requirements for examining journal entries and other adjustments for evidence of possible material misstatement due to fraud.

EXTENT OF SUBSTANTIVE PROCEDURES

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

TIMING OF SUBSTANTIVE PROCEDURES

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

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

a. The assessed risk of material misstatement, including:

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

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

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

b. The nature of the substantive procedures;

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

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

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

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

DUAL-PURPOSE TESTS

.47 In some situations, the auditor might perform a substantive test of a transaction concurrently with a test of a control relevant to that transaction (a "**dual-purpose test**"). In those situations, the auditor should design the dual-purpose test to achieve the objectives of both the test of the control and the substantive test. Also, when performing a dual-purpose test, the auditor should evaluate the results of the test in forming conclusions about both the assertion and the effectiveness of the control being tested. 20/

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.

Footnotes (AS 2301—The Auditor's Responses to the Risks of Material Misstatement):

1/ See also paragraph .06 of AS 1015, *Due Professional Care in the Performance of Work.*

2/ For integrated audits, paragraphs .61 and .B13 of AS 2201, *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/ AS 2110.12–.13 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 AS 2401, *Consideration of Fraud in a Financial Statement Audit,* and paragraphs .04 and .06 of AS 2815, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles."*

4/ AS 1015.07–.09.

5/ AS 2401.13.

6/ For example, potential misstatements regarding disclosures include omission of required disclosures or presentation of inaccurate or incomplete disclosures.

7/ See paragraph .07b of AS 1101, *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.

10/ See AS 2110.71 for factors that the auditor should evaluate in determining which risks are significant risks.

11/ AS 2201.14–.15.

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 AS 1105, *Audit Evidence,* and paragraph .16 of AS 2305, *Substantive Analytical Procedures.*

15/ AS 2110.37–.38 discuss performing a walkthrough.

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 AS 2201.B28.

17/ AS 2201.B1.

18/ AS 2201.A5.

19/ See, e.g., paragraph .14 of AS 2502, *Auditing Fair Value Measurements and Disclosures.*

20/ AS 2315.44 discusses applying audit sampling in dual-purpose tests.

[Effective pursuant to SEC Release No. 34-63606, File No. PCAOB-2010-01 (December 23, 2010)]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 2305: Substantive Analytical Procedures

COMMENT ▼ TOOLS ▼

[The above title is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

Effective for audits of financial statements for periods beginning on or after January 1, 1989, unless otherwise indicated.

See Staff Audit Practice Alert No. 8 for guidance on AS 2305.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

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

Note: AS 2110, *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: AS 2810, *Evaluating Audit Results*, establishes requirements regarding performing analytical procedures as

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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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.03 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.04 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 deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

Analytical Procedures Used as Substantive Tests

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.09 The auditor's reliance on substantive tests to achieve an audit objective related to a particular assertion **fn 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 AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*.)

[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. For audits of fiscal years ending before November 15, 2004, for accelerated filers, and before July 15, 2005, for all other issuers, click here.]

.10 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 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.

[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. For audits of fiscal years ending before November 15, 2004, for accelerated filers, and before July 15, 2005, for all other issuers, click here.]

.16 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. **[fn 2]**

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.21 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. **[fn 3]** In designing such other procedures, the auditor should consider that unexplained differences may indicate an increased risk of material misstatement. (See AS 2810.)

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 deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

[.24]

[Paragraph deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

Footnotes (AS 2305 — Substantive Analytical Procedures):

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

fn 1 Assertions are representations by management that are embodied in financial statement components. See AS 1105, *Audit Evidence*.

[fn 2] *[Footnote deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]*

[fn 3] *[Footnote deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]*

General Auditing Standards

Audit Procedures

2100 Audit Planning and Risk Assessment

2200 Auditing Internal Control Over Financial Reporting

2300 Audit Procedures in Response to Risks-Nature, Timing, and Extent

AS 2301: The Auditor's Responses to the Risks of Material Misstatement

AS 2305: Substantive Analytical Procedures

AS 2310: The Confirmation Process

AS 2315: Audit Sampling

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 2310: The Confirmation Process

COMMENT ▼ TOOLS ▼

Effective for audits of fiscal periods ending after June 15, 1992, unless otherwise indicated.

SUMMARY TABLE OF CONTENTS

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.01 This section provides guidance about the confirmation process in audits performed in accordance with the standards of the PCAOB. 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 paragraphs .03–.08 of AS 2510, *Auditing Inventories*, and the portion of AS 2510.01 that addresses the confirmation of receivables (see paragraphs .34 and .35). This section does not supersede the portion of AS 2510.01 that addresses the observation of inventories.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.02 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 AS 2315, *Audit Sampling*, and AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*. Guidance on the timing of audit procedures is included in AS 2301.

.03 In addition, this section does not address matters described in AS 1210, *Using the Work of a Specialist*, or in AS 2505, *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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.05 AS 1101, *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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.06 Confirmation is undertaken to obtain evidence from third parties about financial statement assertions made by management. See paragraph .08 of AS 1105, *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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.11 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. AS 1105 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 AS 1015, *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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.24 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, **fn 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.

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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.27 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 **fn 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 **fn 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.

.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 agenerally 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. **fn 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.

Footnotes (AS 2310—The Confirmation Process):

fn 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.

fn 2 Paragraphs .09 and .10 of AS 2410, *Related Parties*, provide guidance on examining related-party transactions that have been identified by the auditor.

fn 3 The need to maintain control does not preclude the use of internal auditors in the confirmation process. AS 2605, *Consideration of the Internal Audit Function*, provides guidance on considering the work of internal auditors and on using internal auditors to provide direct assistance to the auditor.

fn 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.

General Auditing Standards

Audit Procedures

2100 Audit Planning and Risk Assessment

2200 Auditing Internal Control Over Financial Reporting

2300 Audit Procedures in Response to Risks-Nature, Timing, and Extent

AS 2301: The Auditor's Responses to the Risks of Material Misstatement

AS 2305: Substantive Analytical Procedures

AS 2310: The Confirmation Process

AS 2315: Audit Sampling

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 2315: Audit Sampling

COMMENT ▼ TOOLS ▼

Effective for periods ended on or after June 25, 1983, unless otherwise indicated.

SUMMARY TABLE OF CONTENTS

.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. **fn 1**

2400 Audit Procedures for Specific Aspects of the Audit
2500 Audit Procedures for Certain Accounts or Disclosures
2600 Special Topics
2700 Auditor's Responsibilities Regarding Supplementary and Other Information
2800 Concluding Audit Procedures
2900 Post-Audit Matters
Auditor Reporting
Matters Relating to Filings Under Federal Securities Laws
Other Matters Associated with Audits

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. **fn 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.03 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 deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.06 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: AS 1105, *Audit Evidence*, discusses the appropriateness of audit evidence, and AS 2810 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." 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 deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.09 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: AS 1101, *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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.11 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 AS 1110, *Relationship of 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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.15 Planning involves developing a strategy for conducting an audit of financial statements. See AS 2101, *Audit Planning*.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.16 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.18 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*.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.]

.18A Paragraphs .08–.09 of AS 2105, *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 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. **fn 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 deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.21 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.23 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.]

.23A 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.

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. **fn 4**

PERFORMANCE AND EVALUATION

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.25 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. **fn 5**, **fn 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, 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. **fn 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. **fn 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, 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). **fn 9**

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.38 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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.39 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 AS 2301, *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 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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.44 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: AS 2301.47 provides additional discussion of the auditor's responsibilities for performing dual-purpose tests.

Selecting a Sampling Approach

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.45 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.]

Appendix—Relating the Risk of Incorrect Acceptance for a Substantive Test of Details to Other Sources of Audit Assurance

.48

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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

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. **fn 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

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 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%).

Footnotes (AS 2315 — Audit Sampling):

fn 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.

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

fn 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 AS 2810, *Evaluating Audit Results*.

fn 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.

fn 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.

fn 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.

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

fn 6 AS 2810.10 through .23 discuss the auditor's consideration of differences between the accounting records and the underlying facts and circumstances.

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

fn 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.

fn 8 For simplicity the remainder of this section will refer to only the rate of deviations.

fn 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.

Footnotes (Appendix—Relating the Risk of Incorrect Acceptance for a Substantive Test of Details to Other Sources of Audit Assurance):

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

fn 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.

General Auditing Standards

Audit Procedures

2100 Audit Planning and Risk Assessment

2200 Auditing Internal Control Over Financial Reporting

2300 Audit Procedures in Response to Risks-Nature, Timing, and Extent

2400 Audit Procedures for Specific Aspects of the Audit

AS 2401: Consideration of Fraud in a Financial Statement Audit

AS 2405: Illegal Acts by Clients

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 2401: Consideration of Fraud in a Financial Statement Audit

COMMENT ▼ TOOLS ▼

Effective for audits of financial statements for periods beginning on or after December 15, 2002.

SUMMARY TABLE OF CONTENTS

See Staff Audit Practice Alerts No. 1, No. 2, No. 5, No. 8, No. 9, and No. 10 for guidance on AS 2401.

Introduction and Overview

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.01 Paragraph .02 of AS 1001, *Responsibilities and Functions of the Independent Auditor*, 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]" **fn 1** 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**

[The following note is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs .14–.15 of AS 2201, *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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.]

.01A AS 2110, *Identifying and Assessing Risks of Material Misstatement*, establishes requirements regarding the process of identifying and assessing risks of material misstatement of the financial statements. AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*, establishes requirements regarding designing and implementing appropriate responses to the risks of material misstatement. AS 2810, *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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.02 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 No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.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. **fn 3** That responsibility is described in AS 1001.03, 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.

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. fn 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). fn 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. 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. fn 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 the standards of the PCAOB 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. 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. **fn 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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.13 Due professional care requires the auditor to exercise professional skepticism. See AS 1015.07 through .09. Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the 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]

[Paragraphs deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

[The following heading is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

Responding to Assessed Fraud Risks

[.46–.50]

[Paragraphs deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

[The following heading is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

RESPONSES INVOLVING THE NATURE, TIMING, AND EXTENT OF PROCEDURES TO BE PERFORMED

[.51]

[Paragraph deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.52 AS 2301.08 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." AS 2301.12 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: AS 2110.71b states that a fraud risk is a significant risk. Accordingly, the requirement for responding to significant risks also applies to fraud risks.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.53 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. **fn 20**
- 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 AS 2110.54)
- 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.

[The following heading is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

ADDITIONAL EXAMPLES OF AUDIT PROCEDURES PERFORMED TO RESPOND TO ASSESSED FRAUD RISKS RELATING TO FRAUDULENT FINANCIAL REPORTING

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

No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.54 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. **fn 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.
  - 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. **fn 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 liabilities). The risk may also relate to significant changes in assumptions relating to recurring estimates. As indicated in AS 2501, *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 AS 2501.09 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.

[The following heading is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

EXAMPLES OF AUDIT PROCEDURES PERFORMED TO RESPOND TO FRAUD RISKS RELATING TO MISAPPROPRIATIONS OF ASSETS

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.55 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.56 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 AS 2301.08 through .15, *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.

[The following heading is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

AUDIT PROCEDURES PERFORMED TO SPECIFICALLY ADDRESS THE RISK OF MANAGEMENT OVERRIDE OF CONTROLS

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.57 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:

1. Obtain an understanding of the entity's financial reporting process **fn 23** and the controls over journal entries and other adjustments. (See paragraphs .59 and .60.)
2. Identify and select journal entries and other adjustments for testing. (See paragraph .61.)

3. Determine the timing of the testing. (See paragraph .62.)
4. 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 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.61 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 the fraud risk.* 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. 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 AS 2101, *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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.63 ***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 **fn 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. AS 2810.24 through .27 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 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 **fn 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]

[Paragraphs deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

Communicating About Possible Fraud to Management, the Audit Committee, and Others fn 37

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004. For audits of fiscal years beginning before December 15, 2012, click here.]

.79 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.80 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. **fn 38** (See paragraph .04 of AS 1305, *Communications About Control Deficiencies in An Audit of Financial Statements*). 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 AS 2110.72–.73) represent significant deficiencies or material weaknesses that should be communicated to senior management and the audit committee.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004. For audits of fiscal years beginning before December 15, 2012, click here]

.81 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 AS 1301, *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 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:

1. To comply with certain legal and regulatory requirements **fn 39**

2. To a successor auditor when the successor makes inquiries in accordance with AS 2610, *Initial Audits—Communications Between Predecessor and Successor Auditors* fn 40
3. In response to a subpoena
4. To a funding agency or other specified agency in accordance with requirements for the audits of entities that receive governmental financial assistance fn 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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.83 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 AS 2110.52 and .53.)
- The procedures performed to obtain information necessary to identify and assess the fraud risks (See AS 2110.47, AS 2110.56 through .58, and AS 2110.65 through .69.)
- The fraud risks that were identified at the financial statement and assertion levels (see AS 2110.59 through .69), and the linkage of those risks to the auditor's response (see AS 2301.05 through .15*)*.
- 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 AS 2110.68.)
- 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 AS 2301.15.)
- 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 AS 2810.05 through .09.)
- The nature of the communications about fraud made to management, the audit committee, and others (See paragraphs .79 through .82.)

[.84]

[Paragraph deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

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 No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.85 A.1 This appendix contains examples of risk factors discussed in AS 2110.65 through .69. 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

1. 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
2. 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

3. 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 **fn 1**
   - Personal guarantees of debts of the entity
4. 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

1. 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
   - 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
2. 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

3. 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

4. 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

1. Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.
2. 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

1. 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
2. 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

Amendment to Section 230, *Due Professional Care in the Performance of Work*

[.86] [Paragraph deleted.]

Amendment to Section 333, *Management Representations*, paragraph .06 and Appendix A [paragraph .16]

[.87] [Paragraph deleted.]

Exhibit

[.88] [Paragraph deleted.]

Footnotes (AS 2401—Consideration of Fraud in a Financial Statement Audit):

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

fn 1 The auditor's consideration of illegal acts and responsibility for detecting misstatements resulting from illegal acts is defined in AS 2405, *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.

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

fn 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.

fn 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."

fn 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.

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

fn 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.

fn 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.

fn 7 For a further discussion of the concept of reasonable assurance, see paragraphs .10 through .13 of AS 1015, *Due Professional Care in the Performance of Work*.

[fns 8–19] [Footnotes deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

fn 20 AS 2305, *Substantive Analytical Procedures*, establishes requirements regarding performing analytical procedures as substantive tests.

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

fn 21 AS 2310, *The Confirmation Process*, establishes requirements regarding the confirmation process in audits of financial statements.

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

fn 22 AS 1210, *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.

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

fn 23 See AS 2110.28 through .32.

fn 24 See AS 2501.02 and .16 for a definition of accounting estimates and a listing of examples.

fn 25 AS 2410, *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, AS 2410.06).

[fns 26–36] *[Footnotes deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]*

fn 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.

fn 38 Alternatively, the auditor may decide to communicate solely with the audit committee.

fn 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.

fn 40 AS 2610 requires the specific permission of the client.

fn 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.

Footnotes (Appendix—Examples of Fraud Risk Factors):

fn 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.

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2100 Audit Planning and Risk Assessment

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2300 Audit Procedures in Response to Risks-Nature, Timing, and Extent

2400 Audit Procedures for Specific Aspects of the Audit

AS 2401: Consideration of Fraud in a Financial Statement Audit

AS 2405: Illegal Acts by Clients

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 2405: Illegal Acts by Clients

COMMENT ▼ TOOLS ▼

Effective for audits of financial statements for periods beginning on or after January 1, 1989, unless otherwise indicated

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See AI 13 for interpretations of AS 2405.

See Staff Audit Practice Alert No. 1 for guidance on AS 2405.

.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 the standards of the PCAOB. The section also provides guidance on the auditor's responsibilities when a possible illegal act is detected.

AS 2410: Related Parties

AS 2415: Consideration of an Entity's Ability to Continue as a Going Concern

2500 Audit Procedures for Certain Accounts or Disclosures

2600 Special Topics

2700 Auditor's Responsibilities Regarding Supplementary and Other Information

2800 Concluding Audit Procedures

2900 Post-Audit Matters

Auditor Reporting

Matters Relating to Filings Under Federal Securities Laws

Other Matters Associated with Audits

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 AS 1001, *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 PCAOB 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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004. For audits of fiscal years beginning before December 15, 2012, click here.]

.08 Normally, an audit in accordance with PCAOB 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 **fn 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 AS 2805, *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

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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.13 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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004. For audits of fiscal years beginning before December 15, 2012, click here.]

.17 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. **[fn1]** 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.19 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.

.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. **fn 2**

Other Considerations in an Audit

.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: **fn 3**

a. When the entity reports an auditor change under the appropriate securities law on Form 8-K **fn 4**

b. To a successor auditor when the successor makes inquiries in accordance with AS 2610, *Initial Audits—Communications Between Predecessor and Successor Auditors* **fn 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.

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.

Footnotes (AS 2405—Illegal Acts by Clients):

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004 .]

fn 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.

[fn 1] *[Footnote 1 of paragraph .17 is deleted, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004 . For audits of fiscal years beginning before December 15, 2012, click here.]*

fn 2 See AS 3101, *Reports on Audited Financial Statements*.

fn 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.]

fn 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.]

fn 5 In accordance with AS 2610, 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.]

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AS 2410: Related Parties [fn *]

COMMENT ▼ TOOLS ▼

Effective for periods ended after September 30, 1983, unless otherwise indicated.

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See AI 14 for interpretations of AS 2410.

See Staff Audit Practice Alerts No. 5 and No. 8 for guidance on AS 2410.

.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 the standards of the PCAOB to identify related party relationships and transactions and to satisfy himself concerning the required financial statement accounting and disclosure. **fn 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 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. **fn 2**

.03 Transactions that because of their nature may be indicative of the existence of related parties include **fn 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 the standards of the PCAOB 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 the standards of the PCAOB, 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 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. **fn 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.

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. **fn 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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.09 After identifying related party transactions, 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. 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. **fn 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 withthe standards of the PCAOB, should be considered. **fn 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.

DISCLOSURE

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.11 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. **fn 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. **fn 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 paragraphs .35 and .36 of AS 3101, *Reports on Audited Financial Statements*).

Footnotes (AS 2410—Related Parties):

[fn *] [Footnote deleted.]

fn 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.

fn 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.]

fn 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."

fn 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.

fn 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.

fn 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.

fn 7 Arrangements for certain procedures should be made or approved in advance by appropriate client officials.

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

fn 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 AS 2810, *Evaluating Audit Results*.

fn 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."

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2300 Audit Procedures in Response to Risks-Nature, Timing, and Extent

2400 Audit Procedures for Specific Aspects of the Audit

AS 2401: Consideration of Fraud in a Financial Statement Audit

AS 2405: Illegal Acts by Clients

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 2415: Consideration of an Entity's Ability to Continue as a Going Concern

COMMENT ▼ TOOLS ▼

Effective for audits of financial statements for periods beginning on or after January 1, 1989, unless otherwise indicated.

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See AI 15 for interpretations of AS 2415.

See Staff Audit Practice Alerts No. 3 and No. 9 for guidance on AS 2415.

.01 This section provides guidance to the auditor in conducting an audit of financial statements in accordance with the standards of the PCAOB with respect to evaluating whether there is substantial doubt about the entity's ability to continue as a going concern. **fn 1**, **fn 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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.02 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 AS 1105, *Audit Evidence*.

.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). **fn 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. fn 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.]

.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. fn 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 AS 3101.

.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 AS 3101.

.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 .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.]

[The following heading is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004.]

Communications with Audit Committees

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004.]

.17A Paragraph .17 of AS 1301, *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.]

Footnotes (AS 2415—Consideration of an Entity's Ability to Continue as a Going Concern):

fn 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" (AI 23.33–.38).

fn 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).

fn 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 PCAOB auditing standards. [Footnote revised, January 2001, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

fn 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 AS 3101, *Reports on Audited Financial Statements*).

fn 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.].

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AS 2501: Auditing

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 2501: Auditing Accounting Estimates

COMMENT ▼ TOOLS ▼

Effective for audits of financial statements for periods beginning on or after January 1, 1989, unless otherwise indicated.

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See AI 16 for interpretations of AS 2501.

See Staff Audit Practice Alerts No. 3, No. 4, No. 7, and No. 9 and Staff Questions and Answers on Auditing the Fair Value of Share Options Granted to Employees for guidance on AS 2501.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.01 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 the standards of the PCAOB. 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. **fn 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.

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

+ Other Matters Associated with Audits

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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.07 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 **fn 2** and are properly disclosed. **fn 3**

IDENTIFYING CIRCUMSTANCES THAT REQUIRE ACCOUNTING ESTIMATES

.08 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—

[The following subparagraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

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 (AS 2110, *Identifying and Assessing Risks of Material Misstatement*).
2. Changes in the methods of accumulating information.
3. Information concerning identified litigation, claims, and assessments (AS 2505, *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.

1. Inquire of management about the existence of circumstances that may indicate the need to make an accounting estimate.

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. fn 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 No. 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

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.

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 (AS 1210,*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.

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release No. 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.13 *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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.14 AS 2810.24 through .27 discuss the auditor's responsibilities for assessing bias and evaluating accounting estimates in relationship to the financial statements taken as a whole.

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.

Appendix—Examples of Accounting Estimates

.16 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	Contracts:

selling prices and future costs are involved	
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
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

Footnotes (AS 2501—Auditing Accounting Estimates):

fn 1 Additional examples of accounting estimates included in historical financial statements are presented in paragraph .16.

fn 2 AS 2815, *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 AS 2815 amended, effective for reports issued or reissued on or after June 30, 2001, by Statement on Auditing Standards No. 93.]

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

fn 3 See paragraph .31 of AS 2810, *Evaluating Audit Results*.

fn 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.

General Auditing Standards
Audit Procedures
2100 Audit Planning and Risk Assessment
2200 Auditing Internal Control Over Financial Reporting
2300 Audit Procedures in Response to Risks-Nature, Timing, and Extent
2400 Audit Procedures for Specific Aspects of the Audit
2500 Audit Procedures for Certain Accounts or Disclosures
AS 2501: Auditing

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 2502: Auditing Fair Value Measurements and Disclosures

COMMENT ▼ TOOLS ▼

Effective for audits of financial statements for periods beginning on or after June 15, 2003, unless otherwise indicated.

SUMMARY TABLE OF CONTENTS

See Staff Audit Practice Alerts No. 2, No. 3, and No. 9 and Staff Questions and Answers on Auditing the Fair Value of Share Options Granted to Employees for guidance on AS 2502.

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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.03 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.” **fn 1** Although GAAP may not prescribe the 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

+ Other Matters Associated with Audits

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. fn 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. AS 2501, *Auditing Accounting Estimates*, provides guidance on auditing accounting estimates in general. This section addresses considerations similar to those in AS 2501 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. fn 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. 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.11 AS 2110, *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 AS 2601, *Consideration of an Entity's Use of a Service Organization*, 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.14 Paragraph .A5, second note of AS 2201, *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. **fn 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 AS 1210, *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 AS 1210 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 AS 1210.

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 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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.25 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.32 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), **fn 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 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. **fn 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

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.41 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. **fn 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.42 Some subsequent events or transactions may reflect changes in circumstances occurring after the balance-sheet date and thus do not constitute appropriate 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. **fn 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.44 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. **fn 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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.47 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 AS 2810.12 through .18 and AS 2810.24 through .27).

Management Representations

.48 AS 2805, *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 the standards of the PCAOB 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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004. For audits of fiscal years beginning before December 15, 2012, click here.]

.50 Paragraphs .12–.13 of AS 1301, *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.

Footnotes (AS 2502—Auditing Fair Value Measurements and Disclosures):

fn 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."

fn 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.

fn 3 See, for example, AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*.

[The following footnote is effective November 15, 2008. See PCAOB Release 2008-001 (January 29, 2008). For the footnote effective before November 15, 2008, click here.]

fn 4 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.

fn 5 The auditor also should consider requirements of GAAP that may influence the selection of assumptions (see FASB Concepts Statement No. 7).

fn 6 See AS 2305, *Substantive Analytical Procedures*.

fn 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 AS 2801, *Subsequent Events*.

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

fn 8 See also paragraph .31 of AS 2810, *Evaluating Audit Results*.

fn 9 See Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 2503: Auditing Derivative Instruments, Hedging Activities, and Investments in Securities [fn *]

COMMENT ▼ TOOLS ▼

Effective for audits of financial statements for fiscal years ending on or after June 30, 2001. Early application is permitted.

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See Staff Audit Practice Alert No. 3 for guidance on AS 2503.

Applicability

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.01 This section provides guidance to auditors in planning and performing auditing procedures for assertions about derivative instruments, hedging activities, and investments in securities **fn 2** that are made in an entity's financial statements. **fn 3** Those assertions **fn 4** are classified according to five broad categories that are discussed in paragraphs .11 and .12 of AS 1105, *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 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 **fn 5** for investment purposes or to designate it as a hedge of exposure to changes in fair value (referred to as a fair valuehedge), 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 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.

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

No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.06 AS 2101, *Audit Planning*, discusses the auditor's responsibilities for consideration of the use of persons with specialized skill or knowledge. AS 1201, *Supervision of the Audit Engagement*, discusses the auditor's responsibilities for supervision of specialists who are employed by the auditor. AS 1210, *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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.07 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 AS 2605, *Consideration of the Internal Audit Function*.

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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.09 AS 2110, *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.

.10 Controls should be related to management's objectives for financial reporting, operations, and compliance. **[fn 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.

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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.11 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. AS 2110.28 through .32 and AS 2110.B1 through .B6 discuss the information system, including related business processes, relevant to financial reporting. Following the guidance in AS 2601, *Consideration of an Entity's Use of a Service Organization*, 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

[The following note is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

Note: When performing an integrated audit of financial statements and internal control over financial reporting, paragraph .39 of AS 2201, 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 **fn 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
- The contract between the entity and the service organization
- Reports by auditors, **fn 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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.15 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 AS 2110.

.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 AS 2601.
- *b.* An agreed-upon procedures engagement. **fn 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 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. **[fn 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.
- 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. **fn 11**
- 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. **fn 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. **fn 13**

- Inspecting financial instruments and other agreements to identify embedded derivatives.
- 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, **fn 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.

.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. **fn 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 paragraphs .05–.06 of AS 2801, *Subsequent Events*, 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 AS 2801.03.

.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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.35 *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 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 AS 2501, *Auditing Accounting Estimates*. In addition, paragraphs .24 through .27 of AS 2810, *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 AS 1210 or AS 2601. The auditor’s decision about whether such guidance is applicable and which guidance is applicable will depend on the circumstances. The guidance in AS 1210 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 AS 2601 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. **fn 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 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 In situations requiring considerable judgment, the auditor should consider the guidance in—

[The following subparagraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

a. AS 2501 on obtaining and evaluating sufficient appropriate evidential matter to support significant accounting estimates.

b. AS 1210 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 paragraph .04 of AS 2815, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles,"* 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 AS 2815 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.51 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 AS 2810.31.)

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 **fn 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. **fn 18**

.53 The auditor should gather evidential matter to determine whether management complied with the hedge accounting requirements of generally 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 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.

[The following subparagraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

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. **fn 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.

Management Representations

.58 AS 2805, *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. **fn 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.

Footnotes (AS 2503—Auditing Derivative Instruments, Hedging Activities, and Investments in Securities):

[fn 1] [Footnote deleted.]

fn 2 Throughout the remainder of this section, the word security or securities refers to an entity's investment in a security or securities.

fn 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.

fn 4 Throughout the remainder of this section, the word assertion refers to an assertion made in an entity's financial statements.

fn 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.

[fn 6] [Footnote deleted.]

fn 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.

fn 8 AS 2601 provides guidance on auditors' reports on controls placed in operation by a service organization and the operating effectiveness of those controls.

fn 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.]

[fn 10] [Footnote deleted.]

fn 11 AS 2310, *The Confirmation Process*, 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.

fn 12 AS 2305, *Substantive Analytical Procedures*, provides guidance to auditors in using analytical procedures as substantive tests.

fn 13 AS 2310.17 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.

fn 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.

fn 15 See paragraphs .16–.18 of AS 3101, *Reports on Audited Financial Statements*.

fn 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.

fn 17 FASB Statement No. 133 requires formal documentation of prescribed aspects of hedging relationships at the inception of the hedge.

fn 18 FASB Statement No. 133 requires management to periodically reassess the effectiveness of hedging relationships whenever financial statements or earnings are reported, and at least every three months. It also requires that all assessments of effectiveness be consistent with the risk management strategy documented for the particular hedging relationship.

fn 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.

fn 20 Appendix B of AS 2805.17 provides illustrative representations about derivatives and securities transactions.

General Auditing Standards
Audit Procedures
2100 Audit Planning and Risk Assessment
2200 Auditing Internal Control Over Financial Reporting
2300 Audit Procedures in Response to Risks-Nature, Timing, and Extent
2400 Audit Procedures for Specific Aspects of the Audit
2500 Audit Procedures for Certain Accounts or Disclosures
AS 2501: Auditing

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 2505: Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments [fn *]

COMMENT ▼ TOOLS ▼

Issue date, unless otherwise indicated: January, 1976.

SUMMARY TABLE OF CONTENTS

See AI 17 for interpretations of AS 2505.

See Staff Audit Practice Alerts No. 1 and No. 7 for guidance on AS 2505.

.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 the standards of the PCAOB.

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*. fn 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 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. fn 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.

INQUIRY OF A CLIENT'S LAWYER FN 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. fn 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.

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 FN 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 (see paragraphs .22 and .23 of AS 3101, *Reports on Audited Financial Statements*). fn 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 AS 3101.45 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.]

Appendix—Illustrative Audit Inquiry Letter to Legal Counsel

.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.]

Exhibit I—Excerpts from Statement of Financial Accounting Standards No. 5: Accounting for Contingencies

[Exhibit deleted.]

Exhibit II—American Bar Association Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information

SUMMARY TABLE OF CONTENTS

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.* fn *

(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 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 **fn †** 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.* **fn ‡***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.* **fn ‡**

(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 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: fn ||

(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 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:

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*] fn †&#82 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.

[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 fn ** 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 fn ** 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] fn †† 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 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,

Footnotes (AS 2505—Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments):

[fn 1] [Footnote deleted.]

fn 2 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 auditing standard for loss contingencies.

fn 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.

fn 4 An illustrative inquiry letter to legal counsel is contained in the Appendix (AS 2505A).

fn 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.

fn 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 (AS 2505C) for the convenience of readers, but is not an integral part of this Statement.

fn 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.

Footnotes (Exhibit II—American Bar Association Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information):

fn * 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.

fn † 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.

fn ‡ 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.

fn ‡ 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.

fn || Citations are to paragraph numbers of FAS 5.

fn †&#82 ***Note:*** See Paragraph 3 of the Statement of Policy and the accompanying Commentary for guidance where the response is limited to material items.

fn ** 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.

fn ** 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.

fn †† ***Note:*** See Paragraph 3 of the Statement of Policy and the accompanying Commentary for guidance where the response is limited to material items.

General Auditing Standards
Audit Procedures
2100 Audit Planning and Risk Assessment
2200 Auditing Internal Control Over Financial Reporting
2300 Audit Procedures in Response to Risks-Nature, Timing, and Extent
2400 Audit Procedures for Specific Aspects of the Audit
2500 Audit Procedures for Certain Accounts or Disclosures
AS 2501: Auditing

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 2510: Auditing Inventories [fn *]

COMMENT ▼ TOOLS ▼

Issue date, unless otherwise indicated: November, 1972.

SUMMARY TABLE OF CONTENTS

.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

Accounting Estimates

AS 2502: Auditing Fair Value Measurements and Disclosures

AS 2503: Auditing Derivative Instruments, Hedging Activities, and Investments in Securities

AS 2505: Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments

AS 2510: Auditing Inventories

2600 Special Topics

2700 Auditor's Responsibilities Regarding Supplementary and Other Information

2800 Concluding Audit Procedures

2900 Post-Audit Matters

Auditor Reporting

Matters Relating to Filings Under Federal Securities Laws

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.] **[fns 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 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

Other Matters Associated with Audits

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 [fn 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.]

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 paragraphs .24 and .67 of AS 3101, *Reports on Audited Financial Statements*. [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.]

Footnotes (AS 2510—Auditing Inventories):

[fn *] [Footnote deleted.]

[fns 1–2] [Superseded November 1991, by Statement on Auditing Standards No. 67.]

[fn 3] [Footnote deleted.]

General Auditing Standards
Audit Procedures
2100 Audit Planning and Risk Assessment
2200 Auditing Internal Control Over Financial Reporting
2300 Audit Procedures in Response to Risks-Nature, Timing, and Extent
2400 Audit Procedures for Specific Aspects of the Audit
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2600 Special

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 2601: Consideration of an Entity's Use of a Service Organization [fn *]

COMMENT ▼ TOOLS ▼

Effective for service auditors' reports dated after March 31, 1993, unless otherwise indicated.

SUMMARY TABLE OF CONTENTS

See AI 18 for interpretations of AS 2601.

See Staff Views on An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements: Guidance for Auditors of Small Public Companies for guidance on AS 2601.

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 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

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 AS 2201, *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
- *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, **fn 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.]

.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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.07 AS 2110, *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.
- 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) **fn 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 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.16 The guidance in paragraph .18 and paragraphs .29 through .31 of AS 2301, *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.

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 paragraph .10*a* of AS 1205, *Part of the Audit Performed by Other Independent Auditors*.

.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 AS 1205.12. 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.

[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.

For audits of fiscal years ending before November 15, 2004, for accelerated filers, and before July 15, 2005, for all other issuers, click here.]

.20 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 AS 1305, *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 the standards of the PCAOB, it should be performed in accordance with the relevant PCAOB auditing 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.23 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 AS 2810, *Evaluating Audit Results*, and AS 2405, *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, fn 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 the standads of the Public Company Accounting Oversight Board (United States) 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 ___.

.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. AS 2315, *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, fn 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 the standards of the Public Company Accounting Oversight Board (United States) 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, 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.] fn 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 ___.

.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.]

Footnotes (AS 2601 — Consideration of an Entity's Use of a Service Organization):

[fn *] [Footnote deleted.]

fn 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.

fn 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.]

fn 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.]

fn 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.]

fn 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.]

General Auditing Standards

Audit Procedures

2100 Audit Planning and Risk Assessment

2200 Auditing Internal Control Over Financial Reporting

2300 Audit Procedures in Response to Risks-Nature, Timing, and Extent

2400 Audit Procedures for Specific Aspects of the Audit

2500 Audit Procedures for Certain Accounts or Disclosures

2600 Special

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 2605: Consideration of the Internal Audit Function

COMMENT ▼ TOOLS ▼

Effective for audits of financial statements for periods ending after December 15, 1991, unless otherwise indicated.

SUMMARY TABLE OF CONTENTS

See Staff Audit Practice Alert No. 11 for guidance on AS 2605.

.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. **fn 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 withthe standards of the PCAOB.

[The following note is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs .16–.19 of AS 2201, *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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.02 One of the auditor's responsibilities in an audit conducted in accordance withstandards of the PCAOB 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. **fn 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 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, **fn 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 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 **fn 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.

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

[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.

For audits of fiscal years ending before November 15, 2004, for accelerated filers, and before July 15, 2005, for all other issuers, click here.]

.16 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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.18 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. **fn 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, **fn 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. **fn 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 2007-005A. Click here to view the note.]

.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 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 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to AS 2201.18–.19, 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

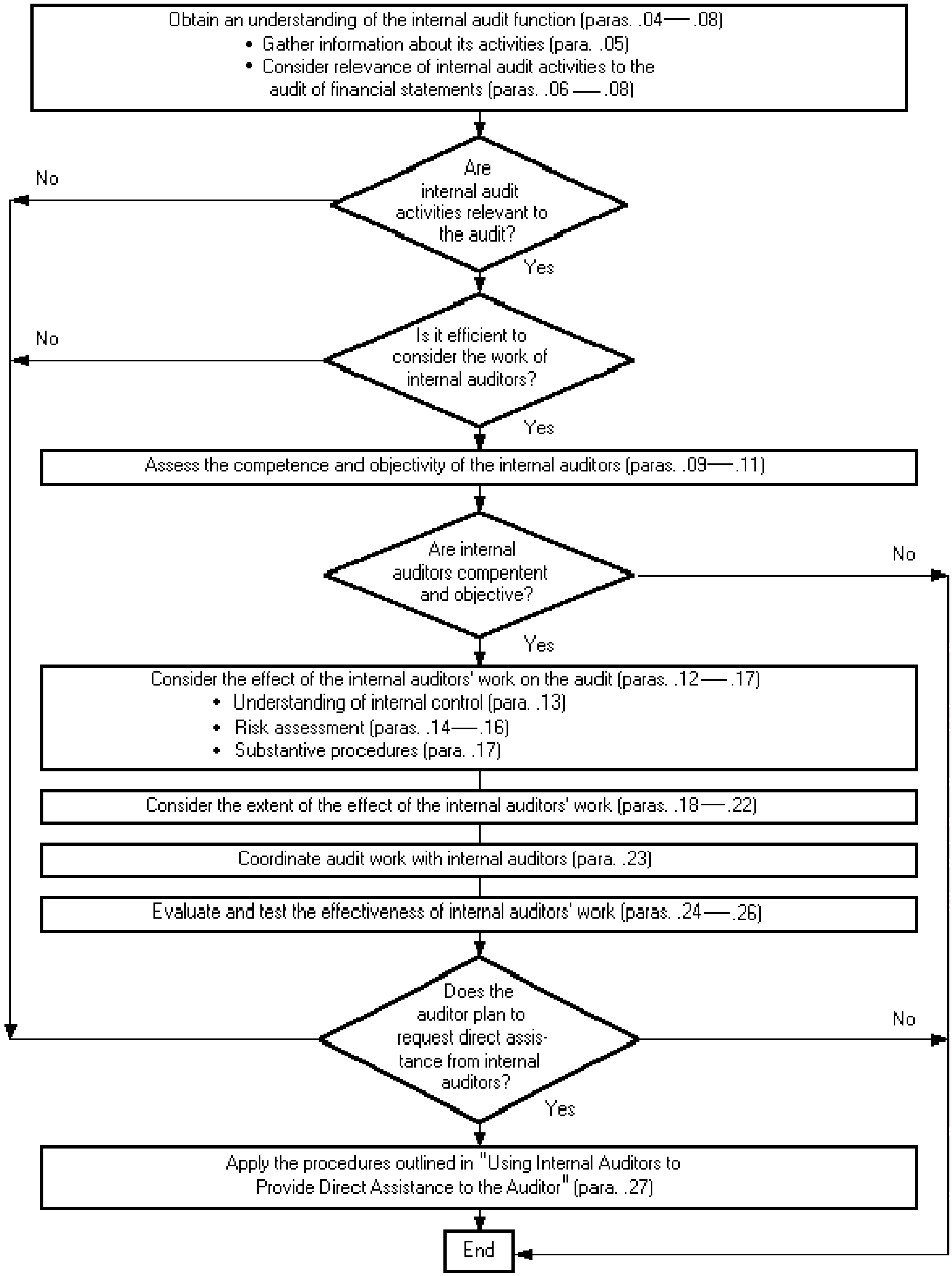
.27 In performing the audit, the auditor may request direct assistance from the internal auditors. This direct assistance relates to work the auditor specifically requests the internal auditors to perform to complete some aspect of the auditor's work. For example, internal auditors may assist the auditor 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, **fn 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.

Appendix—Consideration of the Internal Audit Function

.29


Obtain an understanding of the internal audit function (paras. .04—.08)
• Gather information about its activities (para. .05)
• Consider relevance of internal audit activities to the audit of financial statements (paras. .06 — .08)
Are internal audit activities relevant to the audit?
No
Yes
Is it efficient to consider the work of internal auditors?
No
Yes
Assess the competence and objectivity of the internal auditors (paras. .09—.11)
Are internal auditors compentent and objective?
No
Yes
Consider the effect of the internal auditors' work on the audit (paras. .12—.17)
• Understanding of internal control (para. .13)
• Risk assessment (paras. .14—.16)
• Substantive procedures (para. .17)
Consider the extent of the effect of the internal auditors' work (paras. .18—.22)
Coordinate audit work with internal auditors (para. .23)
Evaluate and test the effectiveness of internal auditors' work (paras. .24—.26)
Does the auditor plan to request direct assis-tance from internal auditors?
No
Yes
Apply the procedures outlined in "Using Internal Auditors to Provide Direct Assistance to the Auditor" (para. .27)
End

Footnotes (AS 2605—Consideration of the Internal Audit Function):

fn 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.

fn 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 PCAOB Rule 3520, *Auditor Independence*.

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

fn 3 AS 2110, *Identifying and Assessing Risks of Material Misstatement*, describes the procedures the auditor performs to obtain an understanding of internal control over financial reporting.

fn 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.

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

fn 5 See paragraph .08 of AS 1105, *Audit Evidence*.

fn 6 See AS 1205, *Part of the Audit Performed by Other Independent Auditors*.

fn 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.

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

fn 8 See AS 1201, *Supervision of the Audit Engagement*, for the type of supervisory procedures to apply.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 2610: Initial Audits—Communications Between Predecessor and Successor Auditors

COMMENT ▼ TOOLS ▼

Effective with respect to acceptance of an engagement after March 31, 1998, unless otherwise indicated.

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See Staff Questions and Answers on Adjustments to Prior-Period Financial Statements Audited by a Predecessor Auditor for guidance on AS 2610.

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 the standards of the PCAOB, 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 **fn 1** or was engaged to perform but did not complete an audit of the financial statements **fn 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. **fn 3** However, an 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.
- Communications to audit committees or others with equivalent authority and responsibility **fn 4** regarding fraud, illegal acts by clients, and internal-control-related matters. **fn 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. **fn 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. **fn 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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.12 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 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, **fn 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.

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.16 The successor auditor should plan and perform the reaudit in accordance with the standards of the PCAOB. The successor auditor should not assume responsibility for the predecessor auditor's work or issue a report that reflects divided responsibility as described in AS 1205. Furthermore, the predecessor auditor is not a specialist as defined in AS 1210, *Using the Work of a Specialist*, nor does the predecessor auditor's work constitute the work of others as described in AS 2605, *Consideration of the Internal Audit Function*, or paragraphs .16–.19 of AS 2201, *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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.18 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 AS 2510, *Auditing 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 AS 2905, *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. fn 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 (*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.

Appendix A—Illustrative Client Consent and Acknowledgment Letter

.24 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: ___________________

Appendix B—Illustrative Successor Auditor Acknowledgment Letter

.25 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 the standards of the Public Company Accounting Oversight Board (United States), 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 the standards of the PCAOB.

- 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 the standards of the PCAOB, (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.]

Footnotes (AS 2610—Initial Audits—Communications Between Predecessor and Successor Auditors):

fn 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.

fn 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.]

fn 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 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.

fn 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.

fn 5 See AS 2401, *Consideration of Fraud in a Financial Statement Audit*; AS 2405, *Illegal Acts by Clients*; *and* AS 1305, *Communication of Internal Control Related Matters Noted in an Audit*.

fn 6 Appendix A [paragraph .24] contains an illustrative client consent and acknowledgment letter.

fn 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.

fn 8 The successor auditor may wish to make inquiries about the professional reputation and standing of the predecessor auditor. See paragraph 10*a* of AS 1205, *Part of the Audit Performed by Other Independent Auditors*.

fn 9 See paragraphs .70 through .74 of AS 3101, *Reports on Audited Financial Statements*, for reporting guidance.

General Auditing Standards
Audit Procedures
2100 Audit Planning and Risk Assessment
2200 Auditing Internal Control Over Financial Reporting
2300 Audit Procedures in Response to Risks-Nature, Timing, and Extent
2400 Audit Procedures for Specific Aspects of the Audit
2500 Audit Procedures for Certain Accounts or Disclosures
2600 Special

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AS 2701: Auditing Supplemental Information Accompanying Audited Financial Statements

COMMENT ▼ TOOLS ▼

Effective Date: For audits of fiscal years ending on or after June 1, 2014.

Final Rule: PCAOB Release No. 2013-008

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Introduction

.01 This standard sets forth the auditor's responsibilities when the auditor of the company's financial statements is engaged to perform audit procedures and report on **supplemental information** 1/ that accompanies financial statements 2/ audited pursuant to Public Company Accounting Oversight Board ("PCAOB") standards.

Objective

.02 The objective of the auditor of the financial statements, when engaged to perform audit procedures and report on supplemental information that accompanies audited financial statements, is to obtain sufficient appropriate audit evidence to express an opinion on whether the supplemental information is fairly stated, in all material respects, in relation to the financial statements as a whole.

Performing Audit Procedures on Supplemental Information Accompanying Audited Financial Statements

.03 The auditor should perform audit procedures to obtain appropriate audit evidence that is sufficient to support the auditor's opinion regarding whether the supplemental information is fairly stated, in all material respects, in relation to the financial statements as a whole. The nature, timing, and extent of audit procedures necessary to obtain sufficient appropriate audit evidence and to report on the supplemental information depends on, among other things:

a. The risk of material misstatement of the supplemental information;

b. The materiality considerations relevant to the information presented;

> Note: When planning and performing the audit procedures to report on supplemental information, the auditor generally should use the same materiality considerations as those used in planning and performing the audit of the financial statements. 3/ However, if applicable regulatory requirements specify a lower materiality level to be applied to certain supplemental information, the auditor should use those prescribed threshold requirements in planning and performing audit procedures for the supplemental information.

c. The evidence obtained from the audit of the financial statements and, if applicable, other engagements by the auditor or affiliates of the firm, 4/ for the period presented; and

> Note: The procedures performed regarding the supplemental information should be planned and performed in conjunction with the audit of the financial statements. For audits of brokers and dealers, the procedures should

be coordinated with the attestation engagements related to compliance or exemption reports required by the U.S. Securities and Exchange Commission ("SEC"). 5/ The auditor should take into account relevant evidence from the audit of the financial statements and, for audits of brokers or dealers, the attestation engagements, in planning and performing audit procedures related to the supplemental information and in evaluating the results of the audit procedures to form the opinion on the supplemental information.

d. Whether a qualified opinion, an adverse opinion, or a disclaimer of opinion was issued on the financial statements.

.04 In performing the audit procedures on supplemental information, the auditor should:

a. Obtain an understanding of the purpose of the supplemental information and the criteria management used to prepare the supplemental information, including relevant regulatory requirements;
b. Obtain an understanding of the methods of preparing the supplemental information, evaluate the appropriateness of those methods, and determine whether those methods have changed from the methods used in the prior period and, if the methods have changed, determine the reasons for and evaluate the appropriateness of such changes;
c. Inquire of management about any significant assumptions or interpretations underlying the measurement or presentation of the supplemental information;
d. Determine that the supplemental information reconciles to the underlying accounting and other records or to the financial statements, as applicable;
e. Perform procedures to test the completeness and accuracy of the information presented in the supplemental information to the extent that it was not tested as part of the audit of financial statements; and
f. Evaluate whether the supplemental information, including its form and content, complies with relevant regulatory requirements or other applicable criteria, if any.

Management Representations

.05 The auditor should obtain written representations from management, including:

a. A statement that management acknowledges its responsibility for the fair presentation of the supplemental information and, if applicable, the form and content of that supplemental information, in conformity with relevant regulatory requirements or other applicable criteria;
b. A statement that management believes the supplemental information, including its form and content, is fairly stated, in all material respects;
c. A statement that the methods of measurement or presentation have not changed from those used in the prior period or, if the methods of measurement or presentation have changed, the reasons for such changes and why those changes are appropriate;
d. If the form and content of the supplemental information is prescribed by regulatory requirements or other

applicable criteria, a statement that the supplemental information complies, in all material respects, with the regulatory requirements or other applicable criteria, and identification of those requirements or other applicable criteria; and

e. A description of any significant assumptions or interpretations underlying the measurement or presentation of the supplemental information, and a statement that management believes that such assumptions or interpretations are appropriate.

Evaluation of Audit Results

.06 To form an opinion on the supplemental information, the auditor should evaluate whether the supplemental information, including its form and content, is fairly stated, in all material respects, in relation to the financial statements as a whole, including whether the supplemental information is presented in conformity, in all material respects, with the relevant regulatory requirements or other applicable criteria.

.07 The auditor should accumulate misstatements regarding the supplemental information identified during performance of audit procedures on the supplemental information and in the audit of the financial statements. 6/ The auditor should communicate accumulated misstatements regarding the supplemental information to management on a timely basis to provide management with an opportunity to correct them.

08. The auditor should evaluate whether uncorrected misstatements related to the supplemental information are material, either individually or in combination with other misstatements, taking into account relevant quantitative and qualitative factors.

> Note: The auditor should evaluate the effect of uncorrected misstatements related to the supplemental information in evaluating the results of the financial statement audit. 7/

.09 The auditor should evaluate the effect of any modifications to the audit report on the financial statements when forming an opinion on the supplemental information:

a. When the auditor expresses a qualified opinion on the financial statements and the basis for the qualification also applies to the supplemental information, the auditor should describe the effects of the qualification on the supplemental information in the report on supplemental information and should express a qualified opinion on the supplemental information.

b. When the auditor expresses an adverse opinion, or disclaims an opinion on the financial statements, the auditor should express an adverse opinion, or disclaim an opinion, on the supplemental information, whichever is appropriate.

Reporting

.10 The auditor's report on supplemental information accompanying audited financial statements should include the following:

a. Identification of the supplemental information.

> Note: Identification may be by descriptive title of the supplemental information or reference to the page number and document where the supplemental information is located.

b. A statement that the supplemental information is the responsibility of management.

c. A statement that the supplemental information has been subjected to audit procedures performed in conjunction with the audit of the financial statements.

> Note: If the financial statements are presented in a separate document from the supplemental information or otherwise are not readily identifiable to the user of the supplemental information, the auditor's report on supplemental information should identify the document containing the company's financial statements.

d. A statement that the audit procedures performed included determining whether the supplemental information reconciles to the financial statements or the underlying accounting and other records, as applicable, and performing procedures to test the completeness and accuracy of the information presented in the supplemental information.

e. A statement that in forming the auditor's opinion, the auditor evaluated whether supplemental information, including its form and content, complies, in all material respects, with the specified regulatory requirements or other criteria, if applicable.

f. A statement, if applicable, that the supplemental information is presented on a basis that differs from the financial statements and is not prescribed by regulatory requirements. When such a statement is made, the report should describe the basis for the supplemental information presentation.

g. An opinion on whether the supplemental information is fairly stated, in all material respects, in relation to the financial statements as a whole, or a disclaimer of opinion.

.11 Unless prescribed by regulatory requirements, the auditor may either include the auditor's report on the supplemental information in the auditor's report on the financial statements or issue a separate report on the supplemental information. If the auditor issues a separate report on the supplemental information, that report should identify the auditor's report on the financial statements.

.12 The date of the auditor's report on the supplemental information in relation to the financial statements as a whole should not be earlier than:

a. The date of the auditor's report on the financial statements from which the supplemental information was derived, and
b. The date on which the auditor obtained sufficient appropriate audit evidence to support the auditor's opinion on the supplemental information in relation to the financial statements as a whole. 8/

.13 The following is an example of an auditor's report on supplemental information when included in the auditor's report on the financial statements:

> The [identify supplemental information] has been subjected to audit procedures performed in conjunction with the audit of [Company's] financial statements. The [supplemental information] is the responsibility of the Company's management. Our audit procedures included determining whether the [supplemental information] reconciles to the financial statements or the underlying accounting and other records, as applicable, and performing procedures to test the completeness and accuracy of the information presented in the [supplemental information]. In forming our opinion on the [supplemental information], we evaluated whether the [supplemental information], including its form and content, is presented in conformity with [specify the relevant regulatory requirement or other criteria, if any]. In our opinion, the [identify supplemental information] is fairly stated, in all material respects, in relation to the financial statements as a whole.

.14 If the auditor determines that the supplemental information is materially misstated in relation to the financial statements as a whole, the auditor should describe the material misstatement in the auditor's report on the supplemental information and express a qualified or adverse opinion on the supplemental information.

.15 If the auditor is unable to obtain sufficient appropriate audit evidence to support an opinion on the supplemental information, the auditor should disclaim an opinion on the supplemental information. In those situations, the auditor's report on the supplemental information should describe the reason for the disclaimer and state that the auditor is unable to and does not express an opinion on the supplemental information.

> Note: If the supplemental information consists of two or more schedules, and the auditor is able to obtain sufficient appropriate audit evidence to support an opinion on some but not all schedules, the auditor may express an opinion on only those schedules for which he or she obtained sufficient appropriate evidence but should disclaim an opinion on the other schedules.

APPENDIX A—Definitions

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

.A2 Supplemental Information—Refers to the following information when it accompanies audited financial statements:

a. Supporting schedules that brokers and dealers are required to file pursuant to Rule 17a-5 under the Securities Exchange Act of 1934; 1/

b. Supplemental information (i) required to be presented pursuant to the rules and regulations of a regulatory authority and (ii) covered by an independent public accountant's report on that information in relation to financial statements that are audited in accordance with PCAOB standards; or

c. Information that is (i) ancillary to the audited financial statements, (ii) derived from the company's accounting books and records, and (iii) covered by an independent public accountant's report on that information in relation to the financial statements that are audited in accordance with PCAOB standards.

Footnotes (AS 2701—Auditing Supplemental Information Accompanying Audited Financial Statements):

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

2/ For purposes of this standard, supplemental information "accompanies financial statements" when it is (1) presented in the same document as the audited financial statements, (2) presented in a document in which the audited financial statements are incorporated by reference, or (3) incorporated by reference in a document containing the audited financial statements.

3/ AS 2105, *Consideration of Materiality in Planning and Performing an Audit*, establishes requirements regarding the auditor's consideration of materiality in planning and performing an audit.

4/ The term "affiliates of the firm" as used in this standard has the same meaning as the term "affiliates of the accounting firm" as defined in PCAOB Rule 3501.

5/ *See* Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, and Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers.*

6/ *See* paragraph .10 of AS 2810, *Evaluating Audit Results*, which discusses the auditor's responsibilities regarding the accumulation of misstatements in an audit of financial statements

7/ *See* AS 2810.17, which discusses evaluation of uncorrected misstatements in the financial statement audit.

8/ AS 2905, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, sets forth procedures to 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 that might have affected the report had he or she then been aware of such facts. AS 2905 applies to situations in which the auditor identifies a material misstatement of the financial statements while performing audit procedures on supplemental information after the date of the auditor's report on the financial statements.

Footnotes (Appendix A—Definitions):

1/ See 17 C.F.R. § 240.17a-5 (d)(2).

General Auditing Standards

Audit Procedures

2100 Audit Planning and Risk Assessment

2200 Auditing Internal Control Over Financial Reporting

2300 Audit Procedures in Response to Risks-Nature, Timing, and Extent

2400 Audit Procedures for Specific Aspects of the Audit

2500 Audit Procedures for Certain Accounts or Disclosures

2600 Special

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 2705: Unaudited Supplementary Information Included in Audited Financial Statements

COMMENT ▼ TOOLS ▼

Issue date, unless otherwise indicated: April, 1988.

See AI 19 for interpretations of AS 2705.

.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.[fn1] This section provides the independent auditor with 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 the standards of the PCAOB 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. **fn2** [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. **[fn3]** 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 AS 2710 apply.

Involvement With Information Outside Financial Statements

.04 The objective of an audit of financial statements in accordance with the standards of the PCAOB 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 PCAOB auditing standards. However, the auditor does have certain responsibilities with respect to information outside the financial statements. The nature of the auditor's responsibility varies with the nature of both the information and the document containing the financial statements.

[The following paragraph is effective for audits of fiscal years ending on or after June 1, 2014. See PCAOB Release No. 2013-008. For audits of fiscal years ending before June 1, 2014, click here.]

.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 **fn4**—is specified in AS 2710. AS 2701, *Auditing Supplemental Information Accompanying Audited Financial Statements*, sets forth the auditor's responsibilities when the auditor of the company's financial statements is engaged to perform audit procedures and report on supplemental information that accompanies financial statements audited pursuant to Public Company Oversight Board standards. 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. fn5

- *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, fn6 and (3) other knowledge obtained during the examination of the financial statements.
- *c.* Consider whether representations on required supplementary information should be included in specific written representations obtained from management (AS 2805, *Management Representations*).
- *d.* Apply additional procedures, if any, that other statements or interpretations 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: fn7 (*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* fn†] 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 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* fn†].

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 AS 2710.07. [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 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.]

Footnotes (AS 2705—Unaudited Supplementary Information Included in Audited Financial Statements):

[fn*] [Footnote deleted.]

[fn1] [Footnote deleted.]

fn2 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 AS 2710, *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.]

[fn3] *[Footnote deleted, effective for audits of fiscal years ending on or after June 1, 2014. See PCAOB Release No. 2013-008. For audits of fiscal years before June 1, 2014, click here.]*

fn4 Client-prepared documents include financial reports prepared by the client but merely reproduced by the auditor on the client's behalf.

fn5 These procedures are also appropriate when the auditor is involved with voluntary presentations of such information required for other entities (see paragraph .03).

fn6 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 paragraph .10 of AS 3315, *Reporting on Condensed Financial Statements and Selected Financial Data*. [Footnote revised, April 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 91.]

[The following footnote is effective for audits of fiscal years ending on or after June 1, 2014. See PCAOB Release No. 2013-008. For audits of fiscal years ending before June 1, 2014, click here.]

fn7 AS 2701 sets forth the auditor's responsibilities when the auditor of the company's financial statements is engaged to perform audit procedures and report on supplemental information that accompanies financial statements audited pursuant to Public Company Accounting Oversight Board standards.

fn† 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.]

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In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AS 2710: Other Information in Documents Containing Audited Financial Statements

COMMENT ▼ TOOLS ▼

Issue date, unless otherwise indicated: December, 1975.

See AI 20 for interpretations of AS 2710.

See Staff Audit Practice Alert No. 4 for guidance on AS 2710.

.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.

[The following paragraph is effective for audits of fiscal years ending on or after June 1, 2014. See PCAOB Release No. 2013-008. For audits of fiscal years ending before June 1, 2014, click here.]

Topics

2700 Auditor's Responsibilities Regarding Supplementary and Other Information

AS 2701: Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents

AS 2705: Unaudited Supplementary Information Included in Audited Financial Statements

AS 2710: Other Information in Documents Containing Audited Financial Statements

2800 Concluding Audit Procedures

2900 Post-Audit Matters

Auditor Reporting

Matters Relating to Filings Under Federal Securities Laws

Other Matters Associated with Audits

.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 AS 6101, *Letters for Underwriters and Certain Other Requesting Parties* fn † and AS 4101, *Responsibilities Regarding Filings Under Federal Securities Statutes* [fn ††]). Also, this section is not applicable to other information on which the auditor is engaged to express an opinion. fn 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 AS 2701, *Auditing Supplemental Information Accompanying Audited Financial Statements* and AS 3305, *Special Reports* [fn **]).

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004. For audits of fiscal years beginning before December 15, 2012, click here.]

.04 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 statements. fn 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004. For audits of fiscal years beginning before December 15, 2012, click here.]

.06 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] [Paragraph deleted effective for audits of fiscal years ending on or after June 1, 2014. See PCAOB Release No. 2013-008. For audits of fiscal years ending before June 1, 2014, click here.]

Footnotes (AS 2710 —Other Information in Documents Containing Audited Financial Statements):

fn † [Section 631, formerly 630, changed by the issuance of Statement on Auditing Standards No. 38 (superseded). AS 6101, formerly 631, changed by the issuance of Statement on Auditing Standards No. 49.] (See AS 6101.)

[fn ††] [Footnote deleted.]

fn 1 Mere reading of other information is an inadequate basis for expressing an opinion on that information.

[fn *] *[Footnote deleted, effective for audits of fiscal years ending on or after June 1, 2014. See PCAOB Release No. 2013-008. For audits of fiscal years ending before June 1, 2014, click here.]*

[fn **] [Footnote deleted.]

fn 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.

General Auditing Standards

Audit Procedures

2100 Audit Planning and Risk Assessment

2200 Auditing Internal Control Over Financial Reporting

2300 Audit Procedures in Response to Risks-Nature, Timing, and Extent

2400 Audit Procedures for Specific Aspects of the Audit

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AS 2801: Subsequent Events

COMMENT ▼ TOOLS ▼

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 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs .93–.97 of AS 2201, *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.

Topics

2700 Auditor's Responsibilities Regarding Supplementary and Other Information

2800 Concluding Audit Procedures

AS 2801: Subsequent Events

AS 2805: Management Representations

AS 2810: Evaluating Audit Results

AS 2815: The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles"

AS 2820: Evaluating Consistency of Financial Statements

2900 Post-Audit Matters

Auditor Reporting

Matters Relating to Filings Under Federal Securities Laws

Other Matters

.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. **fn1** 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 fn2 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. fn* 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 paragraph .19 of AS 3101, *Reports on Audited Financial Statements*.)

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.

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.12 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.

(vi) 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 AS 2505, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.)

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 AS 2805, *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.

Footnotes (AS 2801—Subsequent Events):

fn1 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.

fn2 However, see paragraph .05 as to the desirability of presenting pro forma financial statements to supplement the historical financial statements in certain circumstances.

fn* See also Statement of Financial Accounting Standards No. 16, Prior Period Adjustments (AC section A35).

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AS 2805: Management Representations

COMMENT ▼ TOOLS ▼

Effective for audits of financial statements for periods ending on or after June 30, 1998, unless otherwise indicated.

SUMMARY TABLE OF CONTENTS

See AI 21 for interpretations of AS 2805.

See Staff Audit Practice Alerts No. 1, No. 8, and No. 10 for guidance on AS 2805.

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 the standards of the PCAOB 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. **fn 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 AS 2410, *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.

.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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004. For audits of fiscal years beginning before December 15, 2012, click here.]

.05 Written representations from management should be obtained for all financial statements and periods covered by the auditor's report. **fn 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 No. 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs .75–.77 of AS 2201, *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: **fn 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.

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 **fn 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. **fn 5** (A summary of such items should be included in or attached to the letter.) **fn 6**, **fn 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. **[fn 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. **fn 9**

m. Guarantees, whether written or oral, under which the entity is contingently liable.

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. **fn 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]. **fn 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]. **fn 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. **fn 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. **[fn 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 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.

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release No. 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.09 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 paragraph .05 of AS 3105, *Dating of the Independent Auditor's Report*]. 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. **fn 15** Also, when performing subsequent events procedures in connection with filings under the Securities Act of 1933, the auditor should obtain certain written representations. **fn 16** The 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. **fn 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. **fn 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.

Appendix A—Illustrative Management Representation Letter

.16

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 AS 2401, *Consideration of Fraud in a Financial Statement Audit*, and related parties, in AS 2410, 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
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.

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*. fn 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.*]

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.]

Appendix B—Additional Illustrative Representations

.17

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 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	Note [*X*] to the financial statements discloses all of the matters

strained, with disclosure of management's intentions and the entity's ability to continue as a going concern.	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.
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 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."]
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.

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.
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.
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	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

environmental remediation liabilities and related loss contingencies.	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.
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.]

Appendix C—Illustrative Updating Management Representation Letter

.18

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.]

Footnotes (AS 2805—Management Representations):

fn 1 AS 1015, *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."

fn 2 An illustrative representation letter from management is contained in appendix A, "Illustrative Management Representation Letter" [paragraph .16].

fn 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.

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

fn 4 AS 2810, *Evaluating Audit Results,* indicates that a misstatement can arise from error or fraud and also discusses the auditor's responsibilities for evaluating accumulated misstatements.

fn 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.]

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

fn 6 AS 2810.11 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.

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

fn 7 The communication to management of immaterial misstatements aggregated by the auditor does not constitute a communication pursuant to paragraph .17 of AS 2405, *Illegal Acts by Clients*, Section 10A of the Securities Exchange Act of 1934, or paragraphs .79 through .82 of AS 2401, *Consideration of Fraud in a Financial Statement Audit*. The auditor may have additional communication responsibilities pursuant to AS 2405, Section 10A of the Securities Exchange Act of 1934, or AS 2401.

[fn 8] [Footnote deleted by the issuance of Statement on Auditing Standards No. 99, October 2002.]

fn 9 See AS 2410. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999.]

fn 10 See AS 2405. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999.]

fn 11 See paragraph .05*d* of AS 2505, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments. 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"* (paragraphs .15–.17 of AI 17, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of AS 2505*). [Footnote renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999.]

fn 12 See AS 2505.05*b*. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999.]

fn 13 See paragraph .12 of AS 2801, *Subsequent Events*, paragraph .10 of AS 4101, *Responsibilities Regarding Filings Under Federal Securities Statutes*, and paragraph .45, footnote 31 of AS 6101, *Letters for Underwriters and Certain Other Requesting Parties*. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999.]

[fn 14] [Footnote deleted.]

fn 15 See paragraph .71 of AS 3101, *Reports on Audited Financial Statements*. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999.]

fn 16 See AS 4101.10. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999.]

fn 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.]

fn 18 See AS 3101.22–.34. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999.]

Footnotes (Appendix A—Illustrative Management Representation Letter):

fn 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.]

fn 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.]

General Auditing Standards

Audit Procedures

2100 Audit Planning and Risk Assessment

2200 Auditing Internal Control Over Financial Reporting

2300 Audit Procedures in Response to Risks-Nature, Timing, and Extent

2400 Audit Procedures for Specific Aspects of the Audit

2500 Audit Procedures for Certain Accounts or Disclosures

2600 Special

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 2810: Evaluating Audit Results

COMMENT ▼ TOOLS ▼

Effective Date: For audits of fiscal years beginning on or after Dec. 15, 2010

Final Rule: PCAOB Release No. 2010-004

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.01 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

.02 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

.03 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.

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

.05 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.

.06 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.

.07 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/

.08 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.

.09 *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 .06b, 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 AS 2105, *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 AS 2315, *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.

.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 AS 2105, 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 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 AS 2401, *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 AS 2401.79–.82A, AS 2405, and Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. § 78j-1.

EVALUATING THE QUALITATIVE ASPECTS OF THE COMPANY'S ACCOUNTING PRACTICES

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

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

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

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

b. The identification by management of additional adjusting entries that offset misstatements accumulated by the auditor. If such adjusting entries are identified, the auditor should perform procedures to determine why the underlying misstatements were not identified previously and evaluate the implications on the integrity of management and the auditor's risk assessments, including fraud risk assessments. The auditor also should perform additional procedures as necessary to address the risk of further undetected misstatement.
c. Bias in the selection and application of accounting principles. 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: AS 2401.64–.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.)

.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 AS 2110.)

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: AS 2815, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles,"* establishes requirements for evaluating the presentation of the financial statements. AS 2820, *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 AS 3101, 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 AS 1101, *Audit Risk*, states:

To form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud. Reasonable assurance is obtained by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence. 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, AS 3101 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: AS 2110 establishes requirements on revising the auditor's risk assessment. 22/ AS 2301 discusses the auditor's responsibilities regarding the assessment of control risk and evaluation of control deficiencies in an audit of financial statements. 23/

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

.37 AS 2201, *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. AS 2201 describes the auditor's responsibilities regarding evaluating the results of the audit, including evaluating the identified control deficiencies. 24/

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.

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.
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 .B2l 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.

(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/

- Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques.
- 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.

Footnotes (AS 2810—Evaluating Audit Results):

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.

3/ Paragraphs .46–.48 of AS 2110, *Identifying and Assessing Risks of Material Misstatement*, and paragraph .03 of AS 2305, *Substantive Analytical Procedures.*

4/ AS 2110.47 contains a requirement to perform analytical procedures relating to revenue as part of the risk assessment procedures.

5/ AS 2315.26.

6/ AS 2105.

7/ If the financial statements contain material misstatements, AS 3101, *Reports on Audited Financial Statements*, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AS 3101.35 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/ AS 2405, *Illegal Acts by Clients.*

12/ AS 2105.11–.12.

13/ Misstatements include omission and presentation of inaccurate or incomplete disclosures.

14/ AS 2401.05.

15/ Paragraph .05d of AS 2301, *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 .09 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).

18/ AS 3101.41–.44.

19/ AS 1101.03.

20/ Paragraphs .07–.09 of AS 1105, *Audit Evidence,* discuss the relevance and reliability of audit evidence.

21/ AS 3101.22–.34 contains requirements regarding audit scope limitations.

22/ AS 2110.74.

23/ AS 2301.32–.34.

24/ AS 2201.62–.70 discuss evaluating identified control deficiencies, and AS 2201.71–.73 discuss forming an opinion on the effectiveness of internal control over financial reporting.

Footnotes (Appendix A—Definitions):

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 AS 2401*, 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."

Footnotes (Appendix B—Qualitative Factors Related to the Evaluation of the Materiality of Uncorrected

Misstatements):

1/ If the financial statements contain material misstatements, AS 3101, *Reports on Audited Financial Statements*, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AS 3101.35 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/ AS 2405, *Illegal Acts by Clients.*

Footnotes (Appendix C—Matters That Might Affect the Assessment of Fraud Risks):

1/ Paragraph .09 of AS 1105, *Audit Evidence.*

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 AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* and AS 3101, *Reports on Audited Financial Statements.*)

[Effective pursuant to SEC Release No. 34-63606, File No. PCAOB-2010-01 (December 23, 2010)]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 2815: The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles" [fn *]

COMMENT ▼ TOOLS ▼

Effective for audits of financial statements for periods ending after March 15, 1992, unless otherwise indicated.

See Staff Practice Alert No. 4 and Staff Questions and Answers on References to Authoritative Accounting Guidance in PCAOB Standards for guidance on AS 2815.

[The following paragraph is effective November 15, 2008. See PCAOB Release No. 2008-001 (January 29, 2008). For the paragraph effective before November 15, 2008, click here .]

.01 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 paragraph .08*h* of AS 3101, *Reports on Audited Financial Statements*).

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 deleted, effective November 15, 2008. See PCAOB Release No. 2008-001 (January 29, 2008). Click here to view the paragraph.]

.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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.04 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 AS 2810, *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 AS 2810.31); 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. **fn 1**

[.05]

[Paragraph deleted, effective November 15, 2008. See PCAOB Release No. 2008-001 (January 29, 2008). Click here to view the paragraph.]

.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 deleted, effective November 15, 2008. See PCAOB Release No. 2008-001 (January 29, 2008). Click here to view the paragraph.]

.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. Paragraph .04 of AS 3310, *Special Reports on Regulated Companies*, and AS 3305, *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 (January 29, 2008). Click here to view the paragraphs.]

Footnotes (AS 2815—The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles"):

[fn *] Footnote deleted.]

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

fn 1 The concept of materiality is inherent in the auditor's judgments. That concept involves qualitative as well as quantitative judgments (see AS 2105, *Consideration of Materiality in Planning and Performing an Audit*, and AS 3101.36). [Footnotes 2–9 deleted]

fn † [Footnote deleted]

fn ‡ [Footnote deleted]

fn || [Footnote deleted]

General Auditing Standards

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2100 Audit Planning and Risk Assessment

2200 Auditing Internal Control Over Financial Reporting

2300 Audit Procedures in Response to Risks-Nature, Timing, and Extent

2400 Audit Procedures for Specific Aspects of the Audit

2500 Audit Procedures for Certain Accounts or Disclosures

2600 Special

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AS 2820: Evaluating Consistency of Financial Statements

COMMENT ▼ TOOLS ▼

Effective Date: November 15, 2008

Final Rule: PCAOB Release No. 2008-001

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Consistency and the Auditor's Report on Financial Statements

.01 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.

.02 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.

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2800 Concluding Audit Procedures

AS 2801: Subsequent Events

AS 2805: Management Representations

AS 2810: Evaluating Audit Results

AS 2815: The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles"

AS 2820: Evaluating Consistency of Financial Statements

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.03 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.

.04 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

.05 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.

.06 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.

.07 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/

.08 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 .07 have been met, the auditor should add an explanatory paragraph to the auditor's report, as described in AS 3101, *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 AS 3101.

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 AS 3101.

CORRECTION OF A MATERIAL MISSTATEMENT IN PREVIOUSLY ISSUED FINANCIAL STATEMENTS

.09 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 AS 3101.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.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 paragraph .31 of AS 2810, *Evaluating Audit Results,* and AS 3101.

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 .07 and .08 and AS 3101. 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 .09 and .10 and AS 3101.

Footnotes (AS 2820—Evaluating Consistency of Financial Statements):

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.

[3/] *[Footnote deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]*

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.

[Effective pursuant to SEC Release No. 34-58555, File No. PCAOB-2008-01 (September 16, 2008)]

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2200 Auditing Internal Control Over Financial Reporting

2300 Audit Procedures in Response to Risks-Nature, Timing, and Extent

2400 Audit Procedures for Specific Aspects of the Audit

2500 Audit Procedures for Certain Accounts or Disclosures

2600 Special

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 2901: Consideration of Omitted Procedures After the Report Date

COMMENT ▼ TOOLS ▼

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. fn 1 This circumstance should be distinguished from that described in AS 2905, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, 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, fn 2 peer review, or otherwise, and the omission of a necessary auditing procedure may be disclosed.

Topics

2700 Auditor's Responsibilities Regarding Supplementary and Other Information

2800 Concluding Audit Procedures

2900 Post-Audit Matters

AS 2901: Consideration of Omitted Procedures After the Report Date

AS 2905: Subsequent Discovery of Facts Existing at the Date of the Auditor's Report

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.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 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 AS 2905.05–.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.

Footnotes (AS 2901—Consideration of Omitted Procedures After the Report Date):

fn 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.)

fn 2 See paragraph .02 of AS 1110, *Relationship of Auditing Standards to Quality Control Standards*, and related quality control standards regarding the quality control function of inspection.

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AS 2905: Subsequent Discovery of Facts Existing at the Date of the Auditor's Report

COMMENT ▼ TOOLS ▼

Issue date, unless otherwise indicated: November, 1972.

See AI 22 for interpretations of AS 2905.

.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. **fn 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 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph .98 of AS 2201, *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 **fn 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.]

.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. **fn 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). **fn 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 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.

Footnotes (AS 2905—Subsequent Discovery of Facts Existing at the Date of the Auditor's Report):

fn 1 If the financial statements have not yet been issued, see the guidance found in AS 2801, *Subsequent Events*. [Footnote added, effective September 2002, by Statement on Auditing Standards No. 98.]

fn 2 However, see paragraphs .10–.13 of AS 4101, *Responsibilities Regarding Filings Under Federal Securities Statutes*, 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.]

[The following footnote is effective November 15, 2008. See PCAOB Release 2008-001 (January 29, 2008). For the footnote effective before November 15, 2008, click here.]

fn 3 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.

fn 4 Ibid. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 98, September 2002.]

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AS 3101: Reports on Audited Financial Statements
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AS 3101: Reports on Audited Financial Statements [fn *]

COMMENT ▼ TOOLS ▼

Effective for reports issued or reissued on or after January 1, 1989, unless otherwise indicated.

See AI 23 for interpretations of AS 3101.

See Staff Questions and Answers on Adjustments to Prior-Period Financial Statements Audited by a Predecessor Auditor *for guidance on AS 3101.*

Introduction

.01 This section applies to auditors' reports issued in connection with audits **fn 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 No. 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

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 AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and Appendix C, *Special Reporting Situations*, of AS 2201, for direction on reporting on internal control over financial reporting. In addition, see AS 2201.86–.88, which includes an illustrative combined audit report.

.02 This section does not apply to unaudited financial statements as described in AS 3320, *Association with Financial Statements*, nor does it apply to reports on incomplete financial information or other special presentations as described in AS 3305, *Special Reports*.

[The following paragraph is effective November 15, 2008. See PCAOB Release No. 2008-001 (January 29, 2008). For the paragraph effective before November 15, 2008, click here.]

.03 Justification for the expression of the auditor's opinion rests on the conformity of his or her audit with the standards of the PCAOB and on the findings. This section is concerned primarily with the relationship of the requirements in paragraph .04 to the language of the auditor's report.

.04 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 requirements in paragraph .04 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 paragraph .04 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 requirements in paragraph .04 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 the standards of the PCAOB.

.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* **fn 3**

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 **fn 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 the standards of the PCAOB and an identification of the United States of America as the country of origin of those standards (for example, the standards of the Public Company Accounting Oversight Board (United States))

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 **fn 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 **[fn 6]**) *i.* The manual or printed signature of the auditor's firm

j. 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 **6a/**

k. The date **fn 7** of the audit report

The form of the auditor's standard report on financial statements covering a single year is as follows:

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 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 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*]

[*City and State or Country*]

[*Date*]

The form of the auditor's standard report on comparative financial statements **fn 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 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 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*]

[*City and State or Country*]

[*Date*]

l. 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 **fn 9** paragraph (or other explanatory language) to the standard report. **fn 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 No. 2008-001 (January 29, 2008). For the items effective before November 15, 2008, click here.]

b. There is substantial doubt about the entity's ability to continue as a going concern. fn 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 paragraph .50 of AS 4105, *Reviews of Interim Financial Information*.)

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 paragraph .02 of AS 2705, *Unaudited Supplementary Information Included in Audited Financial Statements*.)

h. Other information in a document containing audited financial statements is materially inconsistent with information appearing in the financial statements. (See paragraph .04 of AS 2710, *Other Information in Documents Containing Audited Financial Statements*.)

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 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 AS 1205, *Part of the Audit Performed by Other Independent Auditors*.)

.13 An example of a report indicating a division of responsibility follows:

<u>Independent Auditor's Report</u>

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 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 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 No. 2008-001 (January 29, 2008). Click here to view the paragraphs.]

LACK OF CONSISTENCY

[The following paragraph is effective November 15, 2008. See PCAOB Release No. 2008-001 (January 29, 2008). For the paragraph effective before November 15, 2008, click here.]

.16 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 .17E are effective November 15, 2008. See PCAOB Release No. 2008-001 (January 29, 2008). For the paragraph effective before November 15, 2008, click here.]

.17A As discussed in AS 2820, *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. **fn 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 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.

[Paragraphs .18A through .18C are effective November 15, 2008. See PCAOB Release No. 2008-001 (January 29, 2008). For the paragraph effective before November 15, 2008, click here.]

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. **fn 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.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.

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—

- 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.

Departures From Unqualified Opinions

QUALIFIED OPINIONS

.20 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—

[The following subparagraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

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).

.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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.22 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 the standards of the PCAOB 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.

.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.]

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.24 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. **fn 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.

.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 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 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.

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 AS 3105 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 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 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 the standards of the PCAOB 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. **fn 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.

[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, fn 16 unless its omission from the auditor's report is recognized as appropriate by a specific PCAOB standard. [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. 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.]

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.49 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 AS 2810, *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 No. 2008-001 (January 29, 2008). Click here to view the paragraph.]

[The following paragraph is effective November 15, 2008. See PCAOB Release No. 2008-001 (January 29, 2008). For the paragraph effective before November 15, 2008, click here.]

.51 ***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.

[The following paragraph is effective November 15, 2008. See PCAOB Release No. 2008-001 (January 29, 2008). For the paragraph effective before November 15, 2008, click here.]

.52 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. **fn 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.]

[The following paragraph is effective November 15, 2008. See PCAOB Release No. 2008-001 (January 29, 2008). For the paragraph effective before November 15, 2008, click here.]

.57 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.

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. **fn 18** If the effects are not reasonably determinable, the report should so state. **fn 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 $_______ 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. **fn 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.]

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.63 An example of a report disclaiming an opinion resulting from an inability to obtain sufficient appropriate evidential matter because of the scope limitation follows:

<u>Independent Auditor's Report</u>

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. **fn 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.

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 Paragraph .04 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 paragraph .04 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 **fn 22** should update **fn 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. **fn 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 AS 3105.01.) [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.]

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.66 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 AS 2810.31.) 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.

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 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 the standards of the Public Company Accounting Oversight Board (United States). 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. **fn 25**

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.]

[The following paragraph is effective November 15, 2008. See PCAOB Release No. 2008-001 (January 29, 2008). For the paragraph effective before November 15, 2008, click here.]

.69 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, and (*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 of a prior period that contains an opinion different from the opinion previously expressed:

<u>Independent Auditor's Report</u>

[*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. **fn 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. **fn 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 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. **fn 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 AS 1205.10 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.]

[The following paragraph is effective November 15, 2008. See PCAOB Release No. 2008-001 (January 29, 2008). For the paragraph effective before November 15, 2008, click here.]

.73 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 AS 3105.05.) [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

PREDECESSOR AUDITOR'S REPORT NOT PRESENTED

[The following paragraph is effective November 15, 2008. See PCAOB Release No. 2008-001 (January 29, 2008). For the paragraph effective before November 15, 2008, click here.]

.74 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, fn 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. fn 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.

[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. [fn 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.]

Footnotes (AS 3101—Reports on Audited Financial Statements):

[fn *] [Footnote deleted.]

fn 1 An audit, for purposes of this section, is defined as an examination of historical financial statements performed in accordance with the standards of the PCAOB in effect at the time the audit is performed. In some cases, regulatory authorities may have additional requirements applicable to entities under their jurisdiction and auditors of such entities should consider those requirements.

[fn 2] [Footnote deleted.]

fn 3 This section does not require a title for an auditor's report if the auditor is not independent. See AS 3320 for guidance on reporting when the auditor is not independent.

fn 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.

fn 5 Paragraphs .03 and .04 of AS 2815, *The Meaning of "Present Fairly in Conformity wth Generally Accepted Accounting Principles,"* 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.]

[fn 6] [Footnote deleted.]

6a/ See SEC Rule 2-02(a) of Regulation S-X, 17 C.F.R. § 210.2-02(a).

fn 7 For guidance on dating the auditor's report, see AS 3105, *Dating of the Independent Auditor's Report*. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

fn 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.]

fn 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.]

fn 10 See footnote 3. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

fn 11 AS 2415, *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.]

fn 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.

fn 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.

fn 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 AS 2510, *Auditing 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.]

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

fn 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.

fn 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.]

fn 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.]

fn 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.]

[The following footnote is effective November 15, 2008. See PCAOB Release No. 2008-001 (January 29, 2008). For the footnote effective before November 15, 2008, click here.]

fn 19 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.]

[The following footnote is effective November 15, 2008. See PCAOB Release No. 2008-001 (January 29, 2008). For the footnote effective before November 15, 2008, click here.]

fn 20 AS 3320.05 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.]

fn 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 the standards of the PCAOB. 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.]

fn 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 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.]

fn 23 An updated report on prior-period financial statements should be distinguished from a reissuance of a previous report (see AS 3105.06 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.]

fn 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.]

[The following footnote is effective November 15, 2008. See PCAOB Release No. 2008-001 (January 29, 2008). For the footnote effective before November 15, 2008, click here.]

fn 25 It is assumed that the independent auditor has been able to satisfy himself or herself as to the consistency of application of generally accepted accounting principles. See AS 2820 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.]

fn 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.]

fn 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.]

fn 28 See AS 2805, *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.]

fn 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.]

fn 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.]

[fn 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.]

General Auditing Standards

Audit Procedures

Auditor Reporting

3100 Reporting on Audits of Financial Statements

AS 3101: Reports on Audited Financial Statements

AS 3105: Dating of the Independent Auditor's Report

3300 Other Reporting Topics

Matters Relating to Filings Under Federal Securities Laws

Other Matters Associated with Audits

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 3105: Dating of the Independent Auditor's Report

COMMENT ▼ TOOLS ▼

Issue date, unless otherwise indicated: November, 1972.

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[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.01 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. **fn 1** However, with respect to filings under the Securities Act of 1933, reference should be made to paragraphs.10–.13 of AS 4101, *Responsibilities Regarding Filings Under Federal Securities Statutes*. **[fn *]**

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 paragraph .03 of AS 2801, *Subsequent Events*) 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. **fn 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, **fn 3** the procedures 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 AS 2801.05) 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. **fn 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.]

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.05 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 AS 2801.12 generally should be extended to that date.

Reissuance of the Independent Auditor's Report

[The following paragraph is effective for audits of fiscal years ending on or after June 1, 2014. See PCAOB Release No. 2013-008

. For audits of fiscal years ending before June 1, 2014, click here.]

.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 AS 4101 **[fn *]** as to an auditor's responsibility when his report is included in a registration statement filed under the Securities Act of 1933 and see paragraphs .70–.73 of AS 3101, *Reports on Audited Financial Statements*, 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.]

.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 described in AS 2801.08. 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 AS 2801.05 and AS 2801.08) 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.

Footnotes (AS 3105—Dating of the Independent Auditor's Report):

fn 1 See AS 2905, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, 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.

[fn *] [Footnote deleted.]

fn 2 In some cases, a disclaimer of opinion or an adverse opinion may be appropriate.

fn 3 Ibid.

fn 4 Ibid.

[fn *] [Footnote deleted.]

General Auditing Standards
Audit Procedures
Auditor Reporting
3100 Reporting on Audits of Financial Statements
3300 Other Reporting Topics
AS 3305: Special Reports
AS 3310: Special Reports on Regulated Companies
AS 3315: Reporting on Condensed Financial Statements and Selected Financial Data
AS 3320: Association with Financial Statements
Matters Relating to Filings Under Federal Securities

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 3305: Special Reports

COMMENT ▼ TOOLS ▼

Effective for reports issued on or after July 1, 1989, unless otherwise indicated.

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See AI 24 for interpretations of AS 3305.

Introduction

Laws

Other Matters Associated with Audits

.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 The standards of the PCAOB 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 cash flows

d. Statement of changes in owners' equity

e. Statement of assets and liabilities that does not include owners' equity accounts

f. Statement of revenue and expenses

g. Summary of operations

h. Statement of operations by product lines

i. 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 AS 2815, *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 AS 2815.05). In some circumstances, however, a comprehensive basis of accounting other than generally accepted accounting principles may be used. [Title of AS

2815 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. **fn 1**

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 **fn 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 the standards of the PCAOB and includes an identification of the United States of America as the country of origin of those standards (for example, the standards of the Public Company Accounting Oversight Board (United States)).

(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) of the report and should include in the opinion paragraph the appropriate modifying language and a reference to such explanatory paragraph(s). **fn 3**

f. If the financial statements are prepared in conformity with the requirements or financial reporting provisions of a governmental regulatory agency (see paragraph .04a), 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. **fn 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. **fn 5**

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

h. 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. **5a/**

i. The date. **fn 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 paragraph .08 of AS 3101, *Reports on Audited Financial Statements*) 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 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. [fn 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 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.

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 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 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.

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 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.

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.

[Revised, October 2000, to reflect conforming changes necessary to reflect the issuance of Statement on Auditing Standards No. 93.]

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 AS 2815.04. [Title of AS 2815 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 the standards of the PCAOB include rentals, royalties, a profit participation, or a provision for income taxes. **fn 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 the engagement. With the exception of the requirement in AS 3101.08*h*, the standards of the PCAOB are applicable to any engagement to express an opinion on one or more specified elements, accounts, or items of a financial statement. AS 3101.08*h*, 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 AS 3101.64). 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. **fn 9**

b. A paragraph that—

(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 the standards of the PCAOB and includes an identification of the United States of America as the country of origin of those standards (for example, the standards of the Public Company Accounting Oversight Board (United States)).

(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 **fn 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. **fn 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).

(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). **fn 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, **fn 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 city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued. **13a/**

i. The date. **fn 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 .15c 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 AS 3101.11, from the 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 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 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. **fn 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 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 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 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 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 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 FN 16

Independent Auditor's Report

We have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), 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.

We conducted our audit of the schedule in accordance with the standards of the Public Company Accounting Oversight Board. 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 FN 17

Independent Auditor's Report

We have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), 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 the standards of the Public Company Accounting Oversight Board. 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 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. fn 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. **fn 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. **fn 20**
- *b.* A paragraph that states the financial statements were audited in accordance with the standards of the PCAOB and includes an identification of the United States of America as the country of origin of those standards (for example, the standards of the Public Company Accounting Oversight Board (United States)) 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 city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued. **20a/**
- *h.* The date. **fn 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 .20d as well as a paragraph that restricts the use of the report to the specified parties as discussed in paragraph .20e. Following are examples of reports that might be issued:

REPORT ON COMPLIANCE WITH CONTRACTUAL PROVISIONS GIVEN IN A SEPARATE REPORT FN 22

<u>Independent Auditor's Report</u>

We have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), 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

<u>Independent Auditor's Report</u>

We have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), 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.]

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 fn 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 should be related to the presentations taken as a whole. 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. **fn 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 **fn 25** and that the auditor is responsible for expressing an opinion on the financial statements based on the audit. **fn 26**

c. A paragraph that—

   (1) States that the audit was conducted in accordance with the standards of the PCAOB and includes an identification of the United States of America as the country of origin of those standards (for example, the standards of the Public Company Accounting Oversight Board (United States)).

   (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 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. **fn 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). **fn 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 city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued. **28a/**

i. The date. **fn 29**

[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 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 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 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 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. fn 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 fn 31 and that the auditor is responsible for expressing an opinion on the financial statements based on the audit. fn 32

c. A paragraph that—

(1) States that the audit was conducted in accordance with the standards of the PCAOB and includes an identification of the United States of America as the country of origin of those standards (for example, the standards of the Public Company Accounting Oversight Board (United States)).

(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). **fn 33**

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 city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued. **33a/**

j. The date. **fn 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 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.

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.

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, **fn 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 **fn 36** if the accounting change is considered relevant to the presentation. Guidance on reporting in this situation is contained in AS 3101.16 through .18. **[fns 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. **fn 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 AS 3101.12 and .13.

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 AS 3101.68 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.

Footnotes (AS 3305 — Special Reports):

fn 1 This section does not require a title for an auditor's report if the auditor is not independent. See AS 3320, *Association with Financial Statements*, for guidance on reporting when the auditor is not independent.

fn 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.

fn 3 Paragraph .31 discusses other circumstances that may require that the auditor add additional explanatory language to the special report.

fn 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.]

fn 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 AS 3310, *Special Reports on Regulated Companies*. [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.]

5a/ See SEC Rule 2-02(a) of Regulation S-X, 17 C.F.R. § 210.2-02(a).

fn 6 For guidance on dating the auditor's report, see AS 3105, *Dating of the Independent Auditor's Report*. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

[fn 7] [Footnote deleted to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 87.]

fn 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.]

fn 9 See footnote 1. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

fn 10 Alternatively, this requirement can be met by incorporating the description in the introductory paragraph discussed in paragraph .15b above. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

fn 11 When the specified element, account, or item is presented in conformity with an other comprehensive basis of accounting, see paragraph .05d(2). [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

fn 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.]

fn 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 .05f for further reporting guidance in this situation. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

13a/ See footnote 5a.

fn 14 See footnote 6. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

fn 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.]

fn 16 See paragraph .16. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

fn 17 See paragraph .16. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

fn 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 AS 6110, *Compliance Auditing Considerations in Audits of Recipients of Governmental Financial Assistance*. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

fn 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.]

fn 20 See footnote 1. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

20a/ See footnote 5a.

fn 21 See footnote 6. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

fn 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.]

fn 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.]

fn 24 See footnote 1. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

fn 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.]

fn 26 See footnote 2. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

fn 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.]

fn 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.]

28a/ See footnote 5a.

fn 29 See footnote 6. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

fn 30 See footnote 1. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

fn 31 See footnote 25. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

fn 32 See footnote 2. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

fn 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.]

33a/ See footnote 5a.

fn 34 See footnote 6. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

fn 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.]

fn 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.]

[fns 37– [Footnote deleted to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 79.]

38] [Footnote deleted to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 79.]

fn 39 See AS 2415, *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.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 3310: Special Reports on Regulated Companies

COMMENT ▼ TOOLS ▼

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 requirement in paragraph .08*h* of AS 3101, *Reports on Audited Financial Statements*, 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. **fn 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. 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 AS 3101.08), modified as appropriate (see AS 3101.35–.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.]

Footnotes (AS 3310—Special Reports on Regulated Companies):

fn 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 paragraphs .02 and .10 of AS 3305, *Special Reports*). 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.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 3315: Reporting on Condensed Financial Statements and Selected Financial Data [fn *]

COMMENT ▼ TOOLS ▼

Effective for reports issued or reissued on or after January 1, 1989, on condensed financial statements or selected financial data unless otherwise indicated.

[The following paragraph is effective for audits of fiscal years ending on or after June 1, 2014. See PCAOB Release No. 2013-008. For audits of fiscal years ending before June 1, 2014, click here.]

.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

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statements of a public entity fn 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).

AS 2701, *Auditing Supplemental Information Accompanying Audited Financial Statements*, sets forth the auditor's responsibilities when the auditor of the company's financial statements is engaged to perform audit procedures and report on supplemental information that accompanies financial statements audited pursuant to Public Company Accounting Oversight Board standards.

.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 paragraphs .41 through .44 of AS 3101, *Reports on Audited Financial Statements*, AS 3305, *Special Reports*, or other applicable PCAOB auditing standards. fn 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 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*), fn 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, fn 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. fn 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 the standards of the Public Company Accounting Oversight Board (United States), 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.

[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), **fn 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. **fn 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 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: **fn 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 the standards of the Public Company Accounting Oversight Board (United States). 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 the standards of the Public Company Accounting Over 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 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 the standards of the Public Company Accounting Oversight Board, 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.]

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. **fn 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, **fn 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. **fn 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 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 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 the standards of the Public Company Accounting Oversight Board, 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. **fn 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.

Footnotes (AS 3315—Reporting on Condensed Financial Statements and Selected Financial Data):

[fn *] [Footnote deleted.]

fn 1 *Public entity* is defined in footnote 2 of AS 3320, *Association with Financial Statements*.

fn 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 [AR section 200.29 and .30].

fn 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.

fn 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 AS 4101, *Responsibilities Regarding 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.)

fn 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.

fn 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 AS 3101.41 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 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 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.]

fn 7 In considering what other actions, if any, may be appropriate in these circumstances, the auditor may wish to consult his legal counsel.

fn 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 paragraph .03 of AS 4105, *Reviews of Interim Financial Information*.) [Footnote revised, November 2002, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 100.]

fn 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.

fn 10 See footnote 5.

fn 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 AS 3305 are observed.

fn 12 See footnote 7.

General Auditing Standards
Audit Procedures
Auditor Reporting
3100 Reporting on Audits of Financial Statements
3300 Other Reporting Topics
AS 3305: Special Reports
AS 3310: Special Reports on Regulated Companies
AS 3315: Reporting on Condensed Financial Statements and Selected Financial Data
AS 3320: Association with Financial Statements
Matters Relating to Filings Under Federal Securities

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 3320: Association with Financial Statements

COMMENT ▼ TOOLS ▼

Issue date, unless otherwise indicated: November, 1979.

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See AI 25 for interpretations of this section.

.01 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 preceding paragraph 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 paragraph .01. 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 the standards of the PCAOB. **fn2**

.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. **fn3** 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.

.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 AS 3101, *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 AS 4105, *Reviews of 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 **fn4** 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, city and state or country, and date)

This disclaimer of opinion is the means by which the accountant complies with paragraph .01 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. fn5

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 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 paragraphs .02–.10 of AS 3305, *Special Reports*). fn6 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, city and state or country, 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 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 the standards of the PCAOB, 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, city and state or country, 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 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 paragraphs.06–.08 of AS 3105, *Dating of the Independent Auditor's Report*) **fn7** 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, (*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 the standards of the PCAOB.

.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 AS 6101, *Letters for Underwriters and Certain Other Requesting Parties* fn*)

[.20] [Superseded, February 1993, by Statement on Auditing Standards No. 72.] (See AS 6101.)

Footnotes (AS 3320—Association with Financial Statements):

fn2 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.

fn3 However, this section does not apply to data, such as tax returns, prepared solely for submission to taxing authorities.

fn4 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.

fn5 In considering what actions, if any, may be appropriate in the circumstances, the accountant may wish to consult his legal counsel.

fn6 Reference to generally accepted accounting principles in this section includes, where applicable, another comprehensive basis of accounting.

fn7 For reissuance of a compilation or review report, see Statements on Standards for Accounting and Review Services.

fn* [Section 631, formerly 630, changed by the issuance of Statement on Auditing Standards No. 38 (superseded). AS 6101, formerly 631, changed by the issuance of Statement on Auditing Standards No. 49 (superseded). Title of the referenced standard changed, February 1993, to reflect the issuance of Statement on Auditing Standards No. 72.] (See AS 6101.)

General Auditing Standards

Audit Procedures

Auditor Reporting

Matters Relating to Filings Under Federal Securities Laws

AS 4101: Responsibilities Regarding Filings Under Federal Securities Statutes

AS 4105: Reviews of Interim Financial Information

Other Matters Associated with Audits

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 4101: Responsibilities Regarding Filings Under Federal Securities Statutes

COMMENT ▼ TOOLS ▼

Issue date, unless otherwise indicated: April, 1981.

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See AI 26 for interpretations of AS 4101.

.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. **fn 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 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

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 AS 2201, *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.

.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. **fn 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.

.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. **fn 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

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.10 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, 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 paragraph .12 of AS 2801, *Subsequent Events*, 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 AS 3101, *Reports on Audited Financial Statements*).

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 AS 2801 and AS 2905, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*. If the financial statements are appropriately adjusted or the required additional disclosure is made, the auditor should follow the guidance in paragraph .05 of AS 3105, *Dating of the Independent Auditor's Report*, and AS 3105.07 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 AS 2905.08 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004. For audits of fiscal years beginning before December 15, 2012, click here.]

.13 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 AS 2905, because certain provisions of that section may be relevant to his consideration of those matters (see paragraph .46 of AS 4105, *Reviews of Interim Financial Information*).

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.

Footnotes (AS 4101—Responsibilities Regarding Filings Under Federal Securities Statutes):

[fn *] [Footnote deleted.]

fn 1 4 S. E. C. 721 (1939).

fn 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).

fn 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.

General Auditing Standards

Audit Procedures

Auditor Reporting

Matters Relating to Filings Under Federal Securities Laws

AS 4101: Responsibilities Regarding Filings Under Federal Securities Statutes

AS 4105: Reviews of Interim Financial Information

Other Matters Associated with Audits

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 4105: Reviews of Interim Financial Information

COMMENT ▼ TOOLS ▼

Effective for interim periods within fiscal years beginning after December 15, 2002.

SUMMARY TABLE OF CONTENTS

See Staff Audit Practice Alerts No. 4 and No. 5 for guidance on AS 4105.

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 general standards **1a/** 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.

[The following paragraph is effective for reviews of interim periods ending on or after November 15, 2007. See PCAOB Release No. 2007-005A. For reviews of interim periods ending before November 15, 2007, click here.]

.03 The Securities and Exchange Commission (SEC) requires **fn 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. **fn 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 No. 2007-005A. Click here to view the note.]

.04 AS 2610, *Initial Audits—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 **fn 2a**

.05 An accountant may conduct, in accordance with this section, a review of the interim financial information of an SEC registrant fn 3 or of a non-SEC registrant that makes a filing with a regulatory agency fn 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 fn 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

[The following paragraph is effective for reviews of interim periods ending on or after November 15, 2007. See PCAOB Release No. 2007-005A. For reviews of interim periods ending before November 15, 2007, click here.]

.07 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 or she is aware of any material modifications that should be made to the interim financial information for it to conform with the standards of the PCAOB. 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.

[The following heading is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004. For audits of fiscal years beginning before December 15, 2012, click here.]

Establishing an Understanding with the Audit Committee

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004. For audits of fiscal years beginning before December 15, 2012, click here.]

.08 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). **fn 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004. For audits of fiscal years beginning before December 15, 2012, click here.]

.09 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 the standards of the PCAOB. 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 the standards of the PCAOB, 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 principle

  [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.

  For reviews of interim periods ending before November 15, 2004, for accelerated filers, and July 15, 2005, for all other issuers, click here.]

- 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; **fn 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. **fn 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.

[The following paragraph is effective for reviews of interim periods within fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For reviews of interim periods within fiscal years beginning before December 15, 2010, click here.]

.13 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 AS 2110, *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. **fn 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.

[The following paragraph is effective for reviews of interim periods within fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For reviews of interim periods within fiscal years beginning before December 15, 2010, click here.]

.16 *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 AS 2305, *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. **fn 10**

[The following paragraph is effective for reviews of interim periods ending on or after November 15, 2007. See PCAOB Release No. 2007-005A. For reviews of interim periods ending before November 15, 2007, click here.]

.18 *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 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. **fn 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) 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. fn 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 paragraphs .04

through .06 of AS 2710, *Other Information in Documents Containing Audited Financial Statements*.

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.

.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 **fn 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. **fn 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. **fn 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 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: fn 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.

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.) fn 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 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, **fn 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. **fn 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. **[fn 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 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

[The following paragraph is effective for reviews of interim periods ending on or after November 15, 2007. See PCAOB Release No. 2007-005A. For reviews of interim periods ending before November 15, 2007, click here.]

.29 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004. For audits of fiscal years beginning before December 15, 2012, click here.]

.30 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 AS 1301, *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.

[The following paragraph is effective for reviews of interim periods ending on or after November 15, 2007. See PCAOB Release No. 2007-005A. For reviews of interim periods ending before November 15, 2007, click here.]

.32 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 AS 2401, *Consideration of Fraud in a Financial Statement Audit*, AS 2405, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934. **fn 21**

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004. For audits of fiscal years beginning before December 15, 2012, click here.]

.33 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. 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004. For audits of fiscal years beginning before December 15, 2012, click here.]

.34 When conducting a review of interim financial information, the accountant also should determine whether any of the matters described in AS 1301, 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. **fn 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 AS 1301.12. 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004. For audits of fiscal years beginning before December 15, 2012, click here.]

.35 The objective of a review of interim financial information differs significantly from that of an audit. 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004. For audits of fiscal years beginning before December 15, 2012, click here.]

.36 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 AS 1301.25.

The Accountant's Report on a Review of Interim Financial Information fn 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 the standards of

the PCAOB.

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 the standards of the PCAOB, 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).

h. The manual or printed signature of the accountant's firm.

i. 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. **24a/**

j. The date of the review report. (Generally, the report should be dated as of the date of completion of the review procedures. **fn 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: **fn 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 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 information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*City and State or Country*]

[*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. **fn 27**

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 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 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. **fn 28**

[*Signature*]

[*City and State or Country*]

[*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. **fn 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 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 the standards of the Public Company Accounting Oversight Board (United States). 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 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 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*]

[*City and State or Country*]

[*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, **fn 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 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. **fn 31** If information that the accountant believes is necessary for adequate disclosure in conformity with generally accepted accounting principles **fn 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 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 AS 2905, *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. **fn 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.)

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 the standards of the Public Company Accounting Oversight Board 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. fn 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) 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.

Appendix A—Analytical Procedures the Accountant May Consider Performing When Conducting a Review of Interim Financial Information

.54

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). fn 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.
  - 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.

Appendix B—Unusual or Complex Situations to Be Considered by the Accountant When Conducting a Review of Interim Financial Information

.55

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, fn 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

Appendix C—Illustrative Management Representation Letters for a Review of Interim Financial Information

.56

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 AS 2805, *Management Representations*, presents examples of such representations.

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*.

[The following paragraph is effective for reviews of interim periods within fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For reviews of interim periods within fiscal years beginning before December 15, 2010, click here.]

C5. Certain terms are used in the illustrative letters that are described elsewhere in authoritative literature. (Examples are *fraud*, in AS 2401, *Consideration of Fraud in a Financial Statement Audit*, and *related parties*, in AS 2410, *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 AS 2805.08.

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. **fn 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).

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[*Name of chief executive officer and title*]

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[*Name of chief financial officer and title*]

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[*Name of chief accounting officer and title*]

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. fn 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 (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 paragraph .17 of AS 2805, Management Representations.*]
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*]

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[*Name of chief financial officer and title*]

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[*Name of chief accounting officer and title*]

Footnotes (AS 4105—Reviews of Interim Financial Information):

fn 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.

1a/ See AS 1005, *Independence*, AS 1010, *Training and Proficiency of the Independent Auditor*, and AS 1015, *Due Professional Care in the Performance of Work*.

fn 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.

[The following footnote has been renumbered from footnote 2 to footnote 2a.

fn 2a Statements on Standards for Accounting and Review Services provide guidance for review engagements for which this section is not applicable.

fn 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.

fn 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.

fn 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.

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004. For audits of fiscal years beginning before December 15, 2012, click here.]

fn 6 See paragraph .16 of QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

[The following footnote is effective for reviews of interim periods within fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For reviews of interim periods within fiscal years beginning before December 15, 2010, click here.]

fn 7 Paragraphs .10 through .23 of AS 2810, *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.

fn 8 The accountant also may consider reviewing the predecessor accountant's documentation related to reviews of interim period(s) in the prior year.

fn 9 See paragraph .28 of this section.

fn 10 See paragraph .22 of this section.

fn 11 In these circumstances, the accountant ordinarily is in a position similar to that of an auditor who acts as principal auditor (see AS 1205, *Part of the 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.

fn 12 The principal accountant also may request other accountants involved in the engagement, if any, to read the other information.

fn 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.

fn 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.

fn 15 Information that might be disclosed is set forth in paragraph .10 of AS 2415, *Consideration of an Entity's Ability to Continue as a Going Concern*. 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.

fn 16 For additional guidance regarding written management representations, see paragraphs .08 through .12 of AS 2805, *Management Representations*.

fn 17 If a summary of uncorrected misstatements is unnecessary because there were no uncorrected misstatements identified, this representation should be eliminated.

fn 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.

fn 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."

[fn 20] *[Footnote deleted, effective for reviews of interim periods within fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For reviews of interim periods within fiscal years beginning before December 15, 2010, click here.]*

fn 21 See 15 U.S.C. § 78j-1.

[Footnote 22 is deleted, effective for reviews of interim periods ending on or after November 15, 2007. See PCAOB Release No. 2007-005A. Click here to view the footnote.]

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004. For audits of fiscal years beginning before December 15, 2012, click here.]

fn 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.

fn 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.

24a/ See SEC Rule 2-02(a) of Regulation S-X, 17 C.F.R. § 210.2-02(a).

fn 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 AS 3105, *Dating of the Independent Auditor's Report*, and AS 2801, *Subsequent Events*.

fn 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…."

fn 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.

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.

fn 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.

fn 29 See AS 1205.

fn 30 If the circumstances contemplated by Rule 203, *Accounting Principles*, are present, the accountant should refer to the guidance in paragraph .15 of AS 3101, *Reports on Audited Financial Statements*).

fn 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.

fn 32 Such disclosures include those set forth in AS 2415.10. 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.

fn 33 In considering what actions, if any, may be appropriate in these circumstances, the accountant should consider consulting his or her legal counsel.

fn 34 However, an accountant would not be precluded from supporting his or her conclusions by other means in addition to the documentation.

Footnotes (Appendix A—Analytical Procedures the Accountant May Consider Performing When Conducting a Review of Interim Financial Information):

fn 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.

Footnotes (Appendix B—Unusual or Complex Situations to Be Considered by the Accountant When Conducting a Review of Interim Financial Information):

fn 36 The accountant may wish to refer to the guidance in paragraphs .05 and .06 of AS 2501, *Auditing Accounting Estimates*.

Footnotes (Appendix C—Illustrative Management Representation Letters for a Review of Interim Financial Information):

fn 37 If a summary of uncorrected misstatements is unnecessary because no uncorrected misstatements were identified, this representation should be eliminated.

fn 38 If a summary of uncorrected misstatements is unnecessary because no uncorrected misstatements were identified, this representation should be eliminated.

General Auditing Standards

Audit Procedures

Auditor Reporting

Matters Relating to Filings Under Federal Securities Laws

Other Matters Associated with Audits

AS 6101: Letters for Underwriters and Certain Other Requesting Parties

AS 6105: Reports on the Application of Accounting Principles

AS 6110: Compliance Auditing Considerations in Audits of Recipients of Governmental Financial Assistance

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 6101: Letters for Underwriters and Certain Other Requesting Parties

COMMENT ▼ TOOLS ▼

Effective for comfort letters issued on or after June 30, 1993, unless otherwise indicated.

SUMMARY TABLE OF CONTENTS

See AI 27 for interpretations of AS 6101.

Introduction

AS 6115: Reporting on Whether a Previously Reported Material Weakness Continues to Exist

.01 This section [fn 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, fn 2 or to other parties with a statutory due diligence defense under section 11 of the Act, 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. fn 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 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 **fn 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." **fn 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 **fn 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*]

.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 **fn 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 the standards of the Public Company Accounting Oversight Board (United States). 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 the standards of the Public Company Accounting Oversight Board, 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 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 the standards of the PCAOB 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" **fn 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 the standards of the PCAOB) as a defense against possible claims under section 11 of the Act. **fn 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. **fn 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. fn 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 underwriting agreement or purchase agreement (hereafter referred to as the underwriting agreement) but nevertheless ask for such a letter. fn 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, therefore, that the procedures **fn 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. **fn 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 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 **fn 15** or S-K, **fn 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.]

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, fn 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.]

.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 fn 18 to that fact in the comfort letter and discuss the subject matter of the paragraph. fn 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. fn 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— fn 21

a. Condensed financial statements that are derived from audited financial statements (see AS 3315, *Reporting on Condensed Financial Statements and Selected Financial Data*).

b. Selected financial data (see AS 3315).

c. Interim financial information (see AS 4105).

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. fn 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 AS 1305, *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 AS 4105 pertains or (*b*) required supplementary information, to which AS 2705 pertains. AS 4105 and AS 2705 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 AS 4105 and AS 2705, the accountants may do so and report their findings. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

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. **fn22a**

[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.]

COMPLIANCE WITH SEC REQUIREMENTS

.33 The accountants may be requested to express an opinion on whether the financial statements covered by their

fn 23

report comply as to form with the pertinent accounting requirements adopted by the SEC. 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. **fn 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. **fn 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 regarding a forecast, and paragraph .57 regarding Regulation S-K items. **fn 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), **fn 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 AS 4105 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 AS 4105 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 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 fn 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 AS 4105. The accountants may (*a*) state in the comfort letter that they have performed the procedures identified in AS 4105 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 AS 4105, 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 the standards of the PCAOB 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 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 AS 4105 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 AS 4105 review of the financial statements underlying the capsule financial information. If an AS 4105 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 AS 4105 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 **fn 29** thereon to the comfort letter. **fn 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. 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. **fn 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 AS 4105 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 5*b* 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 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. **fn 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.

The following are the disclosure requirements of Regulation S-K **fn 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 above-mentioned 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 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. **fn 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 **fn 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 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.]

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.]

Appendix—Examples

.64

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. fn 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 AS 4105, *Reviews of Interim Financial Information*, 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.

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. fn 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 fn 3 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 Public Company Accounting Oversight Board (United States) for a review of interim financial information as described in AS 4105, *Reviews of 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 fn 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 the standards of the Public Company Accounting Oversight Board. 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 fn 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 statement, for them to be in conformity with generally accepted accounting principles. **fn 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.

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 fn 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 Public Company Accounting Oversight Board (United States) for a review of interim financial information as described in AS 4105, *Reviews of 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 fn 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 the standards of the Public Company Accounting Oversight Board. 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.

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 AS 4105 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 the standards of the Public Company Accounting Oversight Board, we do not express an opinion on whether the prospective financial statements are presented in conformity with AT section 301, *Financial Forecasts and Projections*, 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 the standards of the Public Company Accounting Oversight Board, 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. **fn 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." **fn 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 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 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. **fn 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." **fn 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 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 **fn 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") fn *
Common Stock to Be Outstanding.............	3,250,000 shares fn *
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

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 5b 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 AS 4105 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 **fn 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 Public Company Accounting Oversight Board (United States) for a review of interim financial information as described in AS 4105, *Reviews of 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 ended June 30, 19X6 and 19X5, as set forth in paragraph [*identify location*].

(ii) Performed the procedures specified by the Public Company Accounting Oversight Board for a review of financial information as described in AS 4105 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 the standards of the Public Company Accounting Oversight Board. 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 AS 4105 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 AS 4105 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 **fn 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 **fn 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* fn 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.*

(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 4b(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 the standards of the Public Company Accounting Oversight Board (United States). 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 the standards of the Public Company Accounting Oversight Board, we do not express an opinion on whether the prospective financial statements are presented in conformity with AT section 301, *Financial Forecasts and Projections*, 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 the standards of the Public Company Accounting Oversight Board, 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 AS 4105 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 **fn 18** through that date were set forth therein.

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 the standards of the Public Company Accounting Oversight Board (United States). 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. **fn 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. **fn 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. **fn 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.

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 **fn 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 **fn 23** **fn 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 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 1b, 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 1a and 1b. 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. **fn 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." **fn 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 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 fn 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 the standards of the Public Company Accounting Oversight Board (United States). 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 the standards of the Public Company Accounting Oversight Board, 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 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. fn 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 AS 4105, 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 **fn 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. **fn 30** We have also reviewed the unaudited condensed consolidated financial statements 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. **fn 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 **fn 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 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 **fn 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 the standards of the Public Company Accounting Oversight Board (United States). 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 **fn 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 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.

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.]

Footnotes (AS 6101—Letters for Underwriters and Certain Other Requesting Parties):

[fn 1] [Footnote deleted by the issuance of Statement on Auditing Standards No. 76, September 1995.]

fn 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 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."

fn 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" (paragraphs .01–.09 of AI 27, *Letters for Underwriters and Certain Other Requesting Parties: Auditing Interpretations of AS 6101*).

fn 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.

fn 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."

fn 6 In an acquisition of securities, this sentence could be reworded to refer to "issuance of securities." See paragraph .05.

fn 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.]

fn 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" (paragraphs .12–.15 of AI 26, *Responsibilities Regarding Filings Under Federal Securities Statutes: Auditing Interpretations of AS 4101*). [Footnote renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

fn 9 See AS 4101, *Responsibilities Regarding 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.]

fn 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.]

fn 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.]

fn 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.]

fn 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 AS 4105, *Reviews of Interim Financial Information,* 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.]

fn 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.]

fn 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.]

fn 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.]

fn 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.]

fn 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 AS 4105.50) or (*b*) required supplementary information described in paragraphs .08 through .11 of AS 2705, *Unaudited Supplementary Information Included in Audited Financial Statements*. 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.]

fn 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.]

fn 20 See AS 3105.03 through .08. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

fn 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.]

fn 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.]

fn 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.]

fn 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.]

fn 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.]

fn 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.]

fn 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.]

fn 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.]

fn 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 AS 4105 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.]

fn 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.]

fn 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.]

fn 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.]

fn 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.]

fn 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.]

fn 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 AS 2705. [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.]

fn 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.]

Footnotes (Appendix—Examples):

fn 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.

fn 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.

fn 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.

fn 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."

fn 5 If there has been a change in accounting principle during the interim period, a reference to that change should be included herein.

fn 6 AS 4105 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.

fn 7 See footnote 3 of the Appendix.

fn 8 See footnote 4 of the Appendix.

fn 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. . ."

fn 10 In some cases the company or the underwriter may request that the independent accountants report on "selected financial data" as described in AS 3315, *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).

fn 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.

fn 12 See footnote 10 of the Appendix.

fn 13 See paragraph .55.

fn * Assumes no exercise of the Underwriters' overallotment option. See "Underwriting".

fn 14 See footnote 3 of the Appendix.

fn 15 See footnote 3 of the Appendix.

fn 16 See footnote 5 of the Appendix.

fn 17 See footnote 4 of the Appendix.

fn 18 See footnote 3 of paragraph .03.

fn 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.]

fn 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.]

fn 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.]

fn 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.]

fn 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.]

fn 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.]

fn 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.]

fn 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.]

fn 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.]

fn 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.]

fn 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.]

fn 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.]

fn 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.]

fn 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.]

fn 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.]

fn 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.]

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AS 6101: Letters for Underwriters and Certain Other Requesting Parties

AS 6105: Reports on the Application of Accounting Principles

AS 6110: Compliance Auditing Considerations in Audits of Recipients of Governmental Financial Assistance

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 6105: Reports on the Application of Accounting Principles

COMMENT ▼ TOOLS ▼

Issue date, unless otherwise indicated: July, 1986.

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Introduction

.01 There may be differing interpretations as to whether and, if so, how existing accounting principles apply to new transactions and financial products. **fn 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. **[fn 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.]

AS 6115: Reporting on Whether a Previously Reported Material Weakness Continues to Exist

.02 For purposes of this section, reporting accountant refers to an accountant in public practice [fn 3] who prepares a written report fn 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. fn 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").

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 ("hypothetical transaction"), 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 AS 2815, *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 paragraph .10 of AS 2610, *Initial Audits—Communications Between Predecessor and Successor Auditors*. [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: fn 6

a. A brief description of the nature of the engagement and a statement that the engagement was performed in accordance with the standards of the PCAOB.

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.

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: **fn 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 the standards of the Public Company Accounting Oversight Board (United States).

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.

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.]

Footnotes (AS 6105 — Reports on the Application of Accounting Principles):

fn 1 Accounting principles include generally accepted accounting principles and other comprehensive bases of accounting. See paragraph .04 of AS 3305, *Special Reports*, for a description of other comprehensive bases of accounting.

[fn 2] [Footnote deleted by the issuance of Statement on Auditing Standards No. 97, June 2002.]

[fn 3] [Footnote deleted.]

fn 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.]

fn 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.]

fn 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.]

fn 7 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.]

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AS 6110: Compliance Auditing Considerations in Audits of Recipients of Governmental Financial Assistance

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 6110: Compliance Auditing Considerations in Audits of Recipients of Governmental Financial Assistance

COMMENT ▼ TOOLS ▼

Effective for audits of financial statements and of compliance with laws and regulations for fiscal periods ending after December 31, 1994, unless otherwise indicated.

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Introduction and Applicability

.01 This section **[fn 1]** is applicable when the auditor is engaged to audit a governmental entity under the standards of the PCAOB, 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, fn 2, fn 3 such as single or organization-wide audits or program-specific audits under certain federal or state audit regulations. fn 4

.02 Specifically, this section provides general [fn 5] guidance to the auditor to—

a. Apply the provisions of AS 2405, *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). fn 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, fn 7 or beneficiaries. Among the forms of governmental financial assistance are grants of cash and other assets, loans, loan guarantees, and interest-rate subsidies. fn 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 AS 2405 describes the auditor's responsibility, in an audit performed in accordance with the standards of the PCAOB, 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.

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. fn 9

.09 For financial audits, *Government Auditing Standards* prescribes fieldwork and reporting standards beyond those required by the standards of the PCAOB. 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 the standards of the PCAOB 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.

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). [fn 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 fn 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 the standards of the PCAOB 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. [fn 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 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 fn 13 federal financial assistance programs. [fn 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. fn 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 AS 2315, *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).

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 The standards of the PCAOB 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 an audit of the financial statements in accordance with the standards of the PCAOB 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 the standards of the PCAOB may not satisfy the relevant legal, regulatory, or contractual requirements. **fn 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 the standards of the PCAOB 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 AS 2405.

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.

Footnotes (AS 6110—Compliance Auditing Considerations in Audits of Recipients of Governmental Financial Assistance):

[fn 1] [Footnote deleted to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

fn 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.]

fn 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.]

fn 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.]

[fn 5] [Footnote deleted.]

fn 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.]

fn 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.]

fn 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.]

fn 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.]

[fn 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.]

fn 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.]

[fn 12] [Footnote deleted.]

fn 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.]

[fn 14] [Footnote deleted.]

fn 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 the standards of the PCAOB. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 75, September 1995.]

fn 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.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 6115: Reporting on Whether a Previously Reported Material Weakness Continues to Exist

COMMENT ▼ TOOLS ▼

Effective Date: February 6, 2006

Final Rule: PCAOB Release No. 2005-015

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Appendix B—Background and Basis for Conclusions

Applicability of Standard

.01 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 for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

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 AS 2201**,** *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.

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.02 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 AS 2201 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 AS 2201 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 for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

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 AS 2201.

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

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.04 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 AS 2201 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

.05 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.

.06 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

.07 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.

.08 If all the conditions in paragraph .07 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

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.09 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 AS 2201.

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.10 AS 2201.05 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 for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

> Note: The performance and reporting requirements in AS 2201 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.

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.11 The terms *relevant assertion* and *control objective* have the same meaning as the definitions of those terms in Appendix A, *Definitions*, of AS 2201. **[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.

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.13 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 for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

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 AS 2201.

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

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal periods beginning before December 15, 2010, click here.]

.18 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 for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

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 AS 2201.

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.

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.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.

.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.

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.23 The concept of materiality, as discussed in AS 2201.20, 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

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.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 AS 2201.09 will affect the auditor's procedures.

OBTAINING AN UNDERSTANDING OF INTERNAL CONTROL OVER FINANCIAL REPORTING

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.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 AS 2201, 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 for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

> Note: The second sentence of the paragraph above contemplates that the auditor's previous engagement under AS 2201 resulted in rendering an opinion. If an auditor previously engaged to perform an audit of internal control over financial reporting in accordance with AS 2201 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 .05 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 for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

a. Comply with AS 2201.22–.27 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 for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release

2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

b. Perform the procedures described in AS 2201.34–.38, for those transactions that are directly affected by controls specifically identified by management as addressing the material weakness.

> *[Note deleted, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]*

c. In addition to the communication requirements described in AS 2610, 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.

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.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 AS 2201.

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 .07 of this standard would not be met.

> *[Note deleted, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]*

.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.

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.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 AS 2201.42–.43.

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.32 Consistent with the direction in AS 2201.44–.45, 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 AS 2201.50–.54.

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.33 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 AS 2201.22–.24. 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.

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.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 .B10–.B16 of Appendix B, *Special Topics* of AS 2201 to determine the locations or business units at which to perform procedures.

USING THE WORK OF OTHERS

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.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 AS 2201.16–.19.

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.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 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.

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.38 AS 2201.18–.19 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.

> *[Note deleted, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]*

.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 deleted, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

OPINIONS, BASED IN PART, ON THE WORK OF ANOTHER AUDITOR

.40 The auditor may apply the relevant concepts in AS 1205, *Part of the 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.

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.42 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 for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

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.
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 AS 1215, *Audit Documentation*, are modified in the following respect as they apply to this engagement. AS 1215.14 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 AS 1215 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 .07e 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;

[The following Note is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

> 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 AS 2201. 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;

[The following Note is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

> 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 AS 2201. 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.

[The following Note is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

> 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 AS 2201 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.

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.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 AS 2201, 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 .03 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.

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.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 .07 and .29–.32 of AS 4105, *Reviews of Interim Financial Information*.

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.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 AS 4105.07 and AS 4105.29–.32.

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

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,* f *or 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*]

Footnotes (AS 6115—Reporting on Whether a Previously Reported Material Weakness Continues to Exist):

[1/] *[Footnote deleted effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]*

[The following footnote is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

2/ See AS 2201.42.

3/ The term *successor auditor* has the same meaning as the definition of that term in paragraph .02 of AS 2610, *Initial Audits—Communications Between Predecessor and Successor Auditors*.

[Effective pursuant to SEC Release No. 34-53227, File No. PCAOB-2005-01 (February 6, 2006)]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU110 Footnote 1

COMMENT ▼ TOOLS ▼

[The following footnote was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

fn1 See section 312, *Audit Risk and Materiality in Conducting an Audit*, and section 316, *Consideration of Fraud in a Financial Statement 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 added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 210.03

COMMENT ▼ TOOLS ▼

[The following paragraph was issued in November 1972. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.03

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

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 230.06

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.06

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. The auditor with final responsibility for the engagement should know, at a minimum, the relevant professional accounting and auditing standards and should be knowledgeable about the client. **fn 3** The auditor with final responsibility is responsible for the assignment of tasks to, and supervision of, assistants. **fn 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.]

General Auditing Standards

Audit Procedures

Auditor Reporting

Matters Relating to Filings Under Federal Securities Laws

Other Matters Associated with Audits

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 230.10

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods ending on or after December 15, 1997. It was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

AU 230.10

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. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 230.11

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.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. **fn 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. **fn 6** [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

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AU 230.12

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.12

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. 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. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82. As amended, effective for audits of financial statements for periods beginning on or after December 15, 2002, by Statement on Auditing Standards No. 99.]

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AU 230.13

COMMENT ▼ TOOLS ▼

The following paragraph was effective for audits of financial statements for periods ending on or after December 15, 1997. It was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

[Return to the current version]

AU 230.13

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. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

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AU 230 Footnote 3

COMMENT ▼ TOOLS ▼

[The following footnote was deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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fn 3 See section 311, *Planning and Supervision*, paragraph .07. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

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AU 230 Footnote 4

COMMENT ▼ TOOLS ▼

[The following footnote was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

fn 4 See section 311.11. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 230 Footnote 6

COMMENT ▼ TOOLS ▼

[The following footnote was deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

fn 6 See section 326, *Evidential Matter*. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AI 10: Part of the Audit Performed by Other Independent Auditors: Auditing Interpretations of AS 1205

COMMENT ▼ TOOLS ▼

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 fn 1 in accordance with the standards of the PCAOB and is issuing a report to his client that will also be used by another independent auditor who is acting as a principal auditor. fn 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*—AS 1205.10 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." AS 1205.10*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*—AS 1205 gives guidance to a principal auditor on making inquiries of the other auditor. AS 1205.03 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?

.05 *Interpretation*—AS 2410, *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):
>
> 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. fn 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).
>
> 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 paragraph .11?

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.16 *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. fn 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, AS 1205 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 AS 1205.12 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?

.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 the standards of the PCAOB 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.][fn 6], [fn 7]

Footnotes (AI 10—Part of the Audit Performed by Other Independent Auditors: Auditing Interpretations of AS 1205):

fn 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.

fn 2 *See* AS 1205, *Part of the Audit Performed by Other Independent Auditors*, 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.

fn 3 See paragraphs .04–.07, "Inquiries of the Principal Auditor by the Other Auditor," above.

[fn 4] *[Footnote deleted, effective for fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]*

fn 5 *See* AS 2905, *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.

[fn 6] [Footnote deleted.]

[fn 7] [Footnote deleted.]

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AU 543.01

COMMENT ▼ TOOLS ▼

[The following note was effective for audits of fiscal years ending on or after November 15, 2004, for accelerated filers. It was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

AU 543.01

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 182-185 of PCAOB Auditing Standard No. 2, 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.

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AU 543.12

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.12

[The following paragraph is amended 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 Auditing Standard No. 3. See PCAOB Release No.2004-006.

For periods prior to the effective date of Auditing Standard No. 3, click here.]

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. **fn 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.

AI 11: Using the Work of a Specialist: Auditing Interpretations of AS 1210

COMMENT ▼ TOOLS ▼

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, fn 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.

.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*. **fn 2**

.03 *Question*—What should the auditor consider in determining whether to use the work of a legal specialist **fn 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?

> *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]*

.04 *Interpretation*—Paragraph .06 of AS 1210, *Using the Work of a Specialist*, 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."

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.05 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. **fn 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 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.11 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. AS 1210.13 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, **fn 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, 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. **fn 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." **fn 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 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." **fn 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. **fn 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. **fn 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 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.15 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 . . ." **fn 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 .06 of AS 1105, *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. **fn 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 AS 1210.09 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." **fn 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.

.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. **fn 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 paragraphs .35 through .60 of AS 3101, *Reports on Audited Financial Statements*. 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 AS 3101.22–.26 and AS 3101.61–.63.

[Issue Date: December, 2001.]

Footnotes (AI 11—Using the Work of a Specialist: Auditing Interpretations of AS 1210):

fn 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*.

fn 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.

fn 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.

fn 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.

fn 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).

fn 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.

fn 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.

fn 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.

fn 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."

fn 10 The applicable regulation is 12 CFR section 360.6, effective September 11, 2000.

fn 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.

fn 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.

fn 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.

fn 14 *See* AS 1210.13 as to additional procedures that may be applied.

General Auditing Standards

Audit Procedures

Auditor Reporting

Matters Relating to Filings Under Federal Securities Laws

Other Matters Associated with Audits

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 336.05

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of periods ending on or after December 15, 1994. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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.05

This section does not apply to situations covered by section 311, *Planning and Supervision*, in which a specialist employed by the auditor's firm participates in the audit.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 336.06

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of periods ending on or after December 15, 1994. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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.06

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 competent evidential matter.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 336.13

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of periods ending on or after December 15, 1994. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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.13

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 competent 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 competent 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.)

General Auditing Standards
Audit Procedures
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Matters Relating to Filings Under Federal Securities Laws
Other Matters Associated with Audits

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AU 336 Footnote 1

COMMENT ▼ TOOLS ▼

[The following footnote was effective for audits of periods ending on or after December 15, 1994. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

fn 1 In general, the auditor's education, training, and experience enable him or her to be knowledgeable concerning income tax matters and to be competent to assess their presentation in the financial statements.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AS 1215: Audit Documentation

COMMENT ▼ TOOLS ▼

APPENDIX A

BACKGROUND AND BASIS FOR CONCLUSIONS

(A72) Confidential Client Information.

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.

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.

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 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 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.

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.

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).

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.)

5/ See footnote 4.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

Auditing Standard No. 3 Paragraph 3

COMMENT ▼ TOOLS ▼

[The following subparagraph was 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 took effect beginning with the first quarter ending after the first financial statement audit covered by this standard. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

b. Supervisory personnel who review documentation prepared by assistants on the engagement.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

Auditing Standard No. 3

COMMENT ▼ TOOLS ▼

[The following footnote was effective for audits of fiscal years ending before June 1, 2014. See PCAOB Release No. 2013-007 for audits of fiscal years ending on or after June 1, 2014, or return to the current version.]

2/ Relevant financial statement assertions are described in 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*.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

Auditing Standard No. 3 Paragraph 12

COMMENT ▼ TOOLS ▼

[The following paragraph was 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 took effect beginning with the first quarter ending after the first financial statement audit covered by this standard. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

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.

General Auditing Standards

Audit Procedures

Auditor Reporting

Matters Relating to Filings Under Federal Securities Laws

Other Matters Associated with Audits

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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Auditing Standard No. 3 Paragraph 19

COMMENT ▼ TOOLS ▼

[The following paragraph was 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 took effect beginning with the first quarter ending after the first financial statement audit covered by this standard. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

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* .

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Auditing Standard No. 3 Paragraph 21

COMMENT ▼ TOOLS ▼

[The following paragraph was 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 took effect beginning with the first quarter ending after the first financial statement audit covered by this standard. It was deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

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.

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Auditing Standard No. 7

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of fiscal years ending before June 1, 2014. See PCAOB Release No. 2013-007 for audits of fiscal years ending on or after June 1, 2014, or return to the current version.]

.01 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").

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Auditing Standard No. 7 Paragraph 10 Note

COMMENT ▼ TOOLS ▼

[The following note was effective for engagement quality reviews of audits and interim reviews for fiscal years beginning on or after December 15, 2009. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

Note: A *significant risk* is a risk of material misstatement that is important enough to require special audit consideration.

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Auditing Standard No. 7 Footnote 3

COMMENT ▼ TOOLS ▼

[The following footnote was effective for engagement quality reviews of audits and interim reviews for fiscal years beginning on or after December 15, 2009. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

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-in-charge of an attest engagement.

+ General Auditing Standards
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AI 12: Communications About Control Deficiencies in an Audit of Financial Statements: Auditing Interpretations of AS 1305

COMMENT ▼ TOOLS ▼

[The following note is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

Note: In an audit of financial statements only, auditing interpretation 1 to AS 1305, *Communications About Control Deficiencies in and Audit of Financial Statements*, "Reporting on the Existence of Material Weaknesses," continues to apply except that the term "reportable condition" means "significant deficiency" as defined in paragraph .02 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 AS 2201, *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*—AS 1305 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. AS 1305 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 AS 1305 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 the standards of the Public Company Accounting Oversight Board (United States). 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.]

[2.] Audit Considerations for the Year 2000 Issue

[.08–.17] [Withdrawn July, 2000 by the Audit Issues Task Force.]

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AI 13: Illegal Acts by Clients: Auditing Interpretations of AS 2405

COMMENT ▼ TOOLS ▼

1. Consideration of Internal Control in a Financial Statement Audit and the Foreign Corrupt Practices Act

.01 *Question*—The auditing standards require 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 AS 2405, *Illegal Acts by Clients*, to expand his consideration of internal control beyond that which is required by AS 2110, *Identifying and Assessing Risks of Material Misstatement*?

.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 AS 2405 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. fn 1 If it is determined that there has been a violation of 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 AS 2405.22).

.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.]

Footnotes (AI 13—Illegal Acts by Clients: Auditing Interpretations of AS 2405):

fn 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."

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AI 14: Related Parties: Auditing Interpretations of AS 2410 [fn *]

[1.] Evaluating the Adequacy of Disclosure of Related Party Transactions

[.01–.05] [Withdrawn August, 1983, by SAS No. 45.] (See AS 2410, *Related Parties*.)

[2.] Disclosure of Commonly Controlled Parties

[.06–.09] [Withdrawn August, 1983, by SAS No. 45.] (See AS 2410.)

[3.] Definition of "Immediate Family"

[.10–.11] [Withdrawn August, 1983, by SAS No. 45.] (See AS 2410.)

4. Exchange of Information Between the Principal and Other Auditor on Related Parties

.12 Question—AS 2410.04 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 AS 2410.09, 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 fn 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 to perform those procedures himself, or he may request the other to do so. fn 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. fn 3

[Issue Date: April, 1979.]

6. The Nature and Extent of Auditing Procedures for Examining Related Party Transactions

.16 Question—AS 2410 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 **fn 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. **fn 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—AS 2410.07 states that specific audit procedures should be applied to determine if related parties exist. 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. AS 2410.12 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.]

Footnotes (AI 14—Related Parties: Auditing Interpretations of AS 2410):

[fn *] [Footnote deleted.]

fn 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.

fn 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," paragraphs .01-.03 of AI 10, *Part of the Audit Performed by Other Independent Auditors: Auditing Interpretations of AS 1205*.

fn 3 There is no intention in this interpretation to modify paragraph .12*c* of AS 1205, *Part of the Audit Performed by Other Independent Auditors*, 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.

[The following footnote is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

fn 4 Audit risk and its components are described in AS 1101, *Audit Risk*.

fn 5 See AS 2410.06.

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AI 15: Consideration of an Entity's Ability to Continue as a Going Concern: Auditing Interpretations of AS 2415

COMMENT ▼ TOOLS ▼

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. fn 1 However, if the auditor decides to reissue the report, fn 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 paragraph .12 of AS 2801, *Subsequent Events*, at or near the date of reissuance.
- Consider the factors described in paragraphs .06 through .11 of AS 2415, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, 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.]

Footnotes (AI 15—Consideration of an Entity's Ability to Continue as a Going Concern: Auditing Interpretations of AS 2415):

fn 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.

fn 2 Paragraph .05 of AS 3105, *Dating of the Independent Auditor's Report*, states that an auditor may either "dual-date" or "later-date" his or her reissued report.

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AI 16: Auditing Accounting Estimates: Auditing Interpretations of AS 2501

COMMENT ▼ TOOLS ▼

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?

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.02 *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 the standards of the Public Company Accounting Oversight Board 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.

[The following paragraph is effective for audits of fiscal years ending on or after June 1, 2014. See PCAOB Release No. 2013-008. For audits of fiscal years ending before June 1, 2014, click here.]

.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 look to the requirements in AS 2701, *Auditing Supplemental Information Accompanying Audited Financial Statements*.

[The following paragraph is effective for audits of fiscal years ending on or after June 1, 2014. See PCAOB Release No. 2013-008. For audits of fiscal years ending before June 1, 2014, click here.]

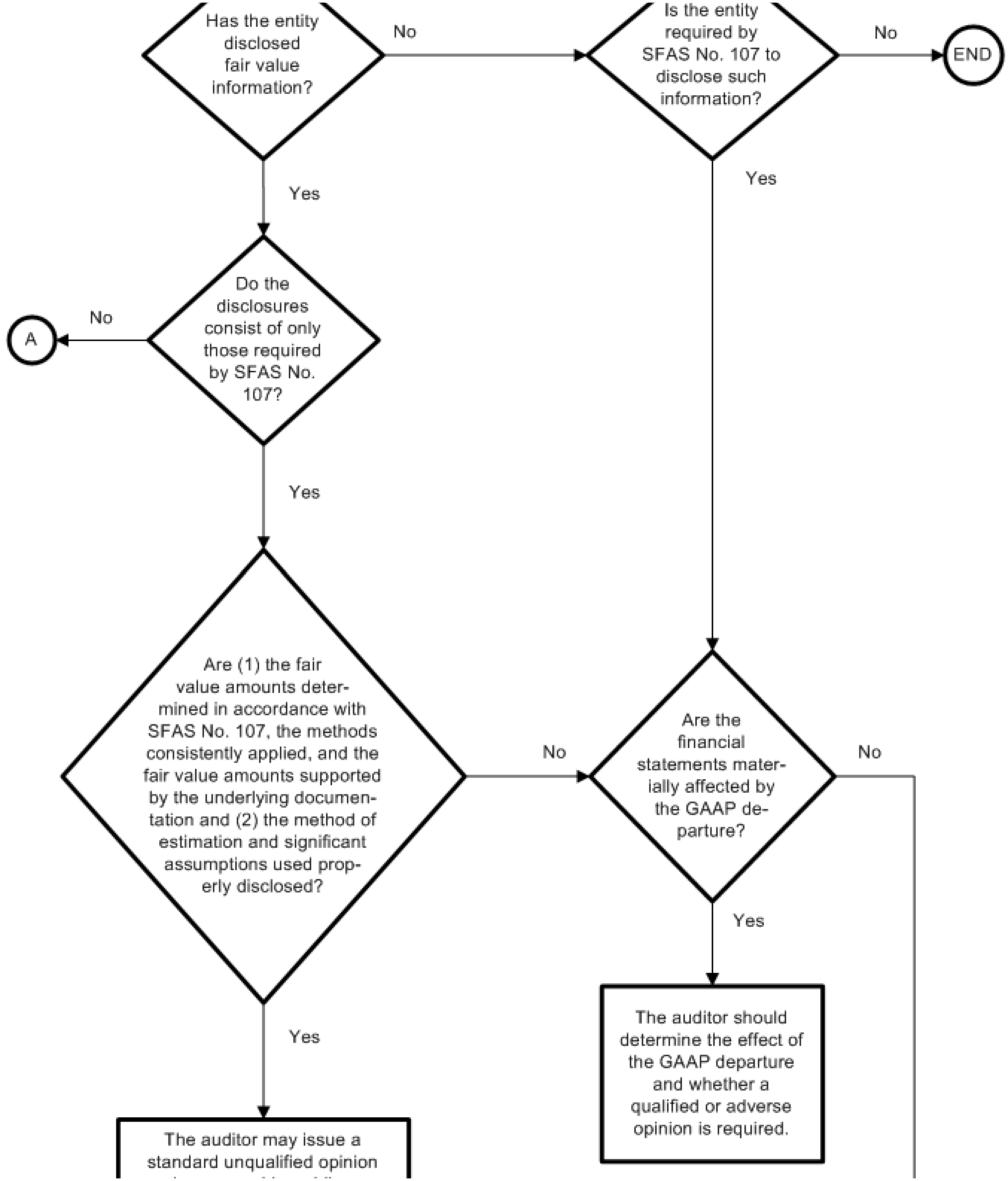
.08 In some situations, the auditor may not be engaged to audit the voluntary information or may be unable to audit it because it does not meet both conditions in paragraph .04 of this interpretation. If the unaudited voluntary disclosures are located on the face of the financial statements or in the footnotes, the voluntary disclosures should be labeled "unaudited." If the unaudited information is presented in a supplemental schedule, the voluntary disclosures should be labeled "unaudited" and the auditor should disclaim an opinion on the unaudited information.

.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 AS 2710, *Other Information in Documents Containing Audited Financial Statements*.

.10 The auditing guidance related to each of these alternatives is presented in the following flowcharts:

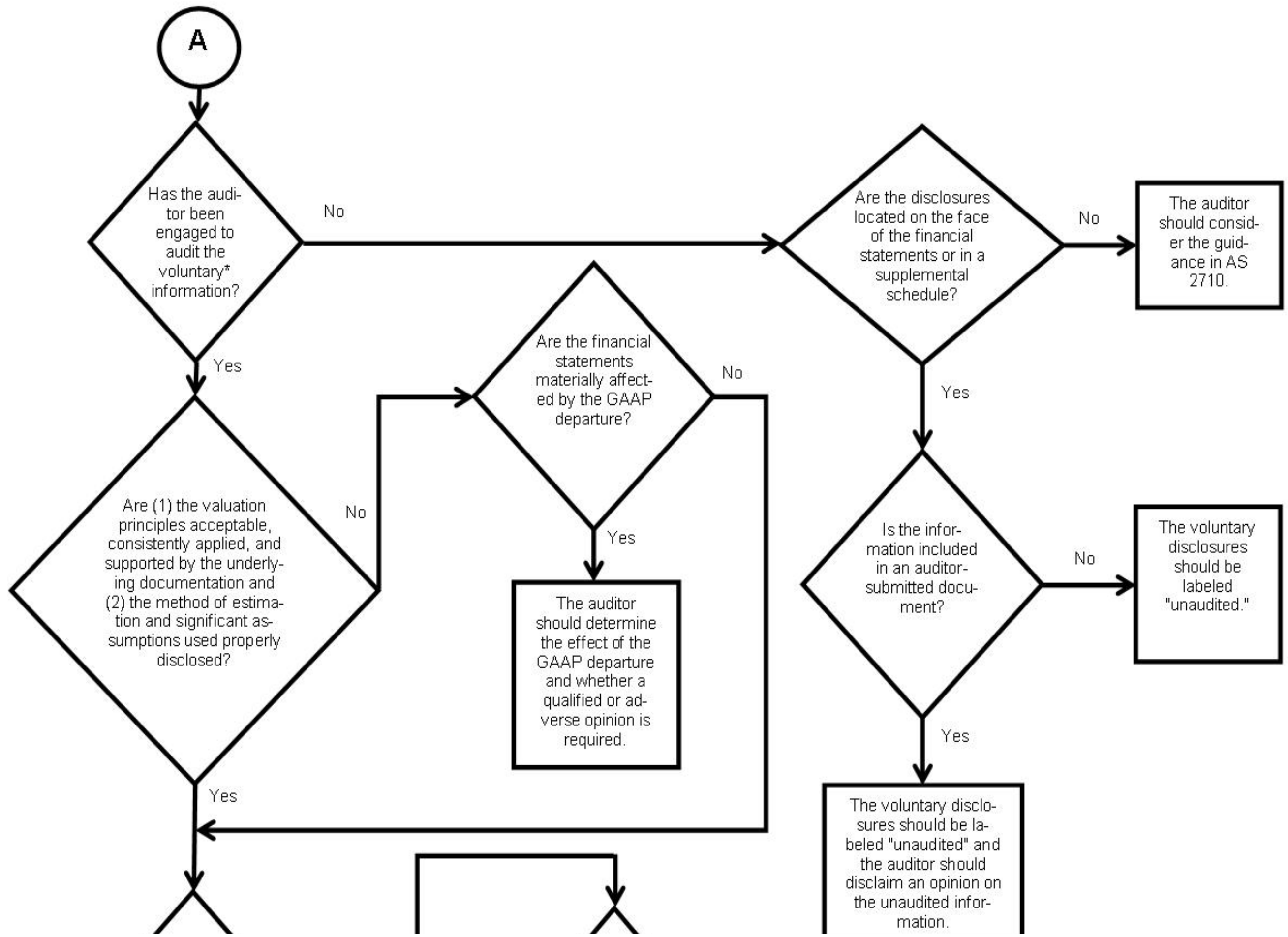
AUDITING GUIDANCE FOR FAIR VALUE INFORMATION

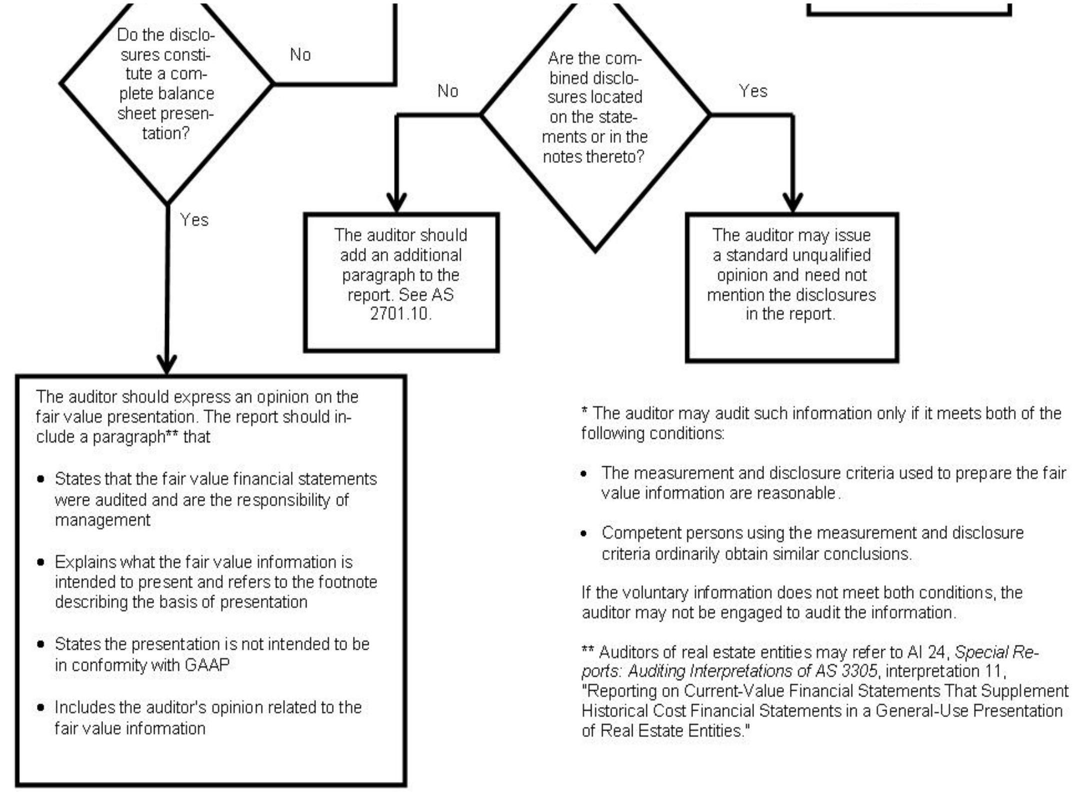
Required fn * Information Only


Has the entity disclosed fair value information?
No
Is the entity required by SFAS No. 107 to disclose such information?
No
END
Yes
Yes
Do the disclosures consist of only those required by SFAS No. 107?
No
A
Yes
Are (1) the fair value amounts deter-mined in accordance with SFAS No. 107, the methods consistently applied, and the fair value amounts supported by the underlying documen-tation and (2) the method of estimation and significant assumptions used prop-erly disclosed?
No
Are the financial statements mater-ially affected by the GAAP de-parture?
No
Yes
Yes
The auditor should determine the effect of the GAAP departure and whether a qualified or adverse opinion is required.
The auditor may issue a standard unqualified opinion

AUDITING GUIDANCE FOR FAIR VALUE INFORMATION
Required and Voluntary Information

[The following flowchart is effective for audits of fiscal years ending on or after June 1, 2014. See PCAOB Release No. 2013-008. For audits of fiscal years ending before June 1, 2014, click here.]





[Issue Date: February, 1993; Revised: October, 2000.]

Footnotes (AI 16—Auditing Accounting Estimates: Auditing Interpretations of AS 2501):

fn * * Required by Statement of Financial Accounting Standards (SFAS) No. 107, *Disclosures about Fair Value of Financial Instruments.*

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AI 17: Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of AS 2505

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 AS 2505, *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

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.04 *Question*—The illustrative form of audit inquiry letter included in the Appendix [AS 2505A] to AS 2505 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?

[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

.05 *Interpretation*—Paragraphs .10 through .12 of AS 2801, *Subsequent Events*, indicate 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.]

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 [AS 2505A] to AS 2505 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 [AS 2505A] to AS 2505, 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*—AS 2505.05*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 AS 2505.13), AS 2505.05*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 [AS 2505A] of AS 2505 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*—AS 2505.09, outlines the matters that should be covered in a letter of audit inquiry. Although AS 2505 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]. fn 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)." fn 2

[Issue Date: June 1983.]

6. Client Has Not Consulted a Lawyer

.15 *Question*—AS 2505.06 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*—AS 2505 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 AS 2505.05 and .07, and the written representation of management regarding litigation, claims, and assessments as required by paragraphs .06*o* and *p* of AS 2805, *Management Representations*. 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 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*—AS 2505.09*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 [AS 2505C] to AS 2505. While Paragraph 5 of the ABA Statement [AS 2505C] 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]. fn 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 AS 2505.14 and in the ABA Policy Statement [AS 2505C], an evaluation furnished by the lawyer 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 paragraphs .45 through .49 of AS 3101, *Reports on Audited Financial Statements*, 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*—AS 2505.06 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*—AS 2505.08 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. fn 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?

.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** fn *

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.

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 [AS 2505C] 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. **fn 5** Confirmation of this understanding should be included in the lawyer's response.

[Issue Date: January, 1997.]

Footnotes (AI 17—Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of AS 2505):

fn 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 AS 2505, the ABA's *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information* [AS 2505C], and excerpts from FASB Statement No. 5 [AC section C59].

fn 2 Two auditing interpretations (see paragraphs .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.

fn 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.

fn 4 This does not alter the caveat in AS 2505.08 that "evidential matter obtained from inside counsel is not a substitute for information outside counsel refuses to furnish."

fn * "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."

fn 5 See Paragraph 6 of the ABA Statement of Policy [AS 2505C] and its Commentary [AS 2505C]. In addition, Annex A to the ABA Statement of Policy [AS 2505C] 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]."

General Auditing Standards

Audit Procedures

Auditor Reporting

Matters Relating to Filings Under Federal Securities Laws

Other Matters Associated with Audits

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AI 18: Consideration of an Entity's Use of a Service Organization: Auditing Interpretations of AS 2601

COMMENT ▼ TOOLS ▼

1. Describing Tests of Operating Effectiveness and the Results of Such Tests

.01 *Question*—Paragraph .44*f* of AS 2601, *Consideration of an Entity's Use of a Service Organization*, 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. AS 2601.44*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 AS 2601.44*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. AS 2601.06 through .17 provide guidance to user auditors on considering the effect of a service organization on a user organization's internal control. Although As 2601.06–.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 AS 2601.06 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. AS 2601.11–.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 the standards of the Public Company Accounting Oversight Board (United States) 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 AS 2601.38 and .54.]

.17 If the service organization has used the inclusive method, the service auditor should perform procedures comparable to those described in AS 2601.12. 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 the standards of the Public Company Accounting Oversight Board (United States) 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. fn 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—AS 2601.32 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 AS 2601.32 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. AS 2601.32 addresses design deficiencies that could adversely affect processing *during the period covered by the service auditor's examination*. AS 2601.32 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 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 AS 2601.32. 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." [fn2]

.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 AS 2710, *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*—AS 2601.29*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. AS 2601.44*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 AS 2601.38 and .54 include illustrative paragraphs that illustrate this caveat. The following excerpt is from AS 2601.54:

> 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 AS 2601.38 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 AS 2601.38 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.]

Footnotes (AI 18—Consideration of an Entity's Use of a Service Organization: Auditing Interpretations of AS 2601):

fn 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).

[fn 2] [Footnote deleted.]

+ General Auditing Standards

+ Audit Procedures

+ Auditor Reporting

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AI 19: Unaudited Supplementary Information Included in Audited Financial Statements: Auditing Interpretations of AS 2705

COMMENT ▼ TOOLS ▼

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 AS 2705, *Unaudited Supplementary Information Included in Audited Financial Statements*?

.02 *Interpretation*—Yes. Also, in addition to the provisions of AS 2705, 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 AS 2705, 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. **fn 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 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, AS 2705 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.]

Footnotes (AI 19—Unaudited Supplementary Information Included in Audited Financial Statements: Auditing Interpretations of AS 2705):

fn 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.

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AI 20: Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of AS 2710

COMMENT ▼ TOOLS ▼

[1.] Reports by Management on Internal Accounting Control[fn 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 paragraph .02 of AS 2710, *Other Information in Documents Containing Audited Financial Statements*, 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 AS 2710, which states that "the auditor has no obligation to perform any procedures to corroborate other information contained in [such] a document." Under AS 2710, 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. **fn 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 over financial reporting contains a material misstatement of fact as described in AS 2710. **fn 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 AS 2710.06.

[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 AS 2710.02 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 AS 2710, which states that "the auditor has no obligation to perform any procedures to corroborate other information contained in [such] a document." Under AS 2710, 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 AS 2710.06.

.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 PCAOB 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. fn 7 If management misstates 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 AS 2710.06.

.15 AI 12, *Communications About Control Deficiencies in an Audit of Financial Statements: Auditing Interpretations of AS 1305*, titled "Reporting on the Existence of Material Weaknesses" (AI 12.01–.07), permits an auditor to report to management that he or she has not become aware of any material weaknesses fn 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 AS 2710. Thus, auditors are not required by AS 2710 to read information contained in electronic sites, or to consider the consistency of other information (as that term is used in AS 2710) 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 different forms, are not contemplated by AS 2710. 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.]

Footnotes (AI 20—Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of AS 2710):

[fn 1-4] [Superseded May, 1994 by Interpretation Nos. 2 and 3, paragraphs .07–.15.]

fn 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.

fn 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.

fn 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 footnote that follows 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. For audits of fiscal years ending before November 15, 2004, for accelerated filers, and before July 15, 2005, for all other issuers, click here.]

fn 8 Paragraph .08 of AS 1305, *Communications about Control Deficiencies in an Audit of Financial Statements*, 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.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AI 21: Management Representations: Auditing Interpretations of AS 2805

COMMENT ▼ TOOLS ▼

1. Management Representations on Violations and Possible Violations of Laws and Regulations

.01 *Question*—AS 2805, *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]. AS 2405, *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 AS 2405?

.03 *Interpretation*—No. AS 2805 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.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AI 22: Subsequent Discovery of Facts Existing at the Date of the Auditor's Report: Auditing Interpretations of AS 2905

COMMENT ▼ TOOLS ▼

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. AS 2905, *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.]

General Auditing Standards
Audit Procedures
Auditor Reporting
Matters Relating to Filings Under Federal Securities Laws
Other Matters Associated with Audits

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AI 23: Reports on Audited Financial Statements: Auditing Interpretations of AS 3101

COMMENT ▼ TOOLS ▼

1. Report of an Outside Inventory-Taking Firm as an Alternative Procedure for Observing Inventories

.01 *Question*—Paragraph .24 of AS 3101, *Reports on Audited Financial Statements*, 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?

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here.]

.02 *Interpretation*—Sufficient appropriate evidential matter for inventories is discussed in paragraphs .09–.12 of AS 2510, *Auditing Inventories*. AS 2510.09 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 AS 2510.10 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 AS 2510.12 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 AS 2510.09–.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 AS 3101.)

[4.] Reports on Consolidated Financial Statements That Include Supplementary Consolidating Information

[.15–.20] [Superseded December 31, 1980, by SAS No. 29.]

[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 AS 3101.)

[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 AS 3101.)

[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 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 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 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 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 AS 3101.)

[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 Reporting 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 AS 2610, *Initial Audits—Communications Between Predecessor and Successor Auditors*.)

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 AS 3101 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 the Standards of the PCAOB and in Accordance with Internal Standards on Auditing

.56 *Question*—AS 3101 states that a basic element of the auditor's report is a statement that the audit was conducted in accordance with the standards of the PCAOB 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 the standards of the PCAOB 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. AS 3101 requires that the auditor indicate in the auditor's report that the audit was conducted in accordance with the standards of the PCAOB and an identification of the United States of America as the country of origin of those standards; however, AS 3101 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. **[fn1]**

.58 When reporting on an audit performed in accordance with the standards of the PCAOB and International Standards on Auditing, the auditor should comply with reporting standards of the PCAOB.

.59 An example of reporting on an audit conducted in accordance with the standards of the PCAOB and in accordance with International Standards on Auditing follows:

> We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States) 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 **fn 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 AS 3101.74, 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 AS 3101 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:

> 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 AS 3101.74. (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 AS 2905, *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. **fn 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 the restatement adjustments is not required to perform procedures to identify all adjustments to the financial statements that may be appropriate. **fn 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. **fn 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 AS 3101.74. 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 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 AS 3101.74?

.75 *Interpretation*—No. As 3101.74 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–.84]

[Rescinded]

Footnotes (AI 23—Reports on Audited Financial Statements: Auditing Interpretations of AS 3101):

[fn 1] [Footnote deleted.]

fn 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.

fn 3 See Securities and Exchange Commission Release No. 33-8070, *Requirements for Arthur Andersen LLP Auditing Clients*.

fn 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 AS 2610. AS 2905 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.

fn 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.

[fn 6] [Footnote deleted.]

[fn 7] [Footnote deleted.]

General Auditing Standards

Audit Procedures

Auditor Reporting

Matters Relating to Filings Under Federal Securities Laws

Other Matters Associated with Audits

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AI 24: Special Reports: Auditing Interpretations of AS 3305

COMMENT ▼ TOOLS ▼

(.90–.95) Evaluating the Adequacy of Disclosure in Financial Statements Prepared on the Cash, Modified Cash, or Income Tax Basis of Accounting

[1.] Auditor's Report Under Employee Retirement Income Security Act of 1974

[.01–.08] [Withdrawn February 1983. fn *]

[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 AS 3305, *Special Reports*.)]

[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 Soley 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.] [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 AS 3305.)]

[6.] Reporting on Special-Purpose Financial Presentations[fns 3–4]

[.26–.31] [Withdrawn March 1989, by SAS No. 62. (See AS 3305.)]

[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.] [Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

[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 AS 3305.)]

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 the standards of the PCAOB 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*—AS 3305.11 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. fn 5

ILLUSTRATIVE REPORT

Board of Directors

X Insurance Company

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 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

City and State or Country

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–.46] [Paragraphs deleted.]

[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 fn 6 are presented fairly in conformity with generally accepted accounting principles.

.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 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 AS 3305.08, for reporting on financial statements prepared in accordance with the requirements or financial reporting provisions of a government regulatory agency).

.51 AS 3305 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, AS 3305 makes this form of reporting appropriate, even though by law or regulation the accountant's report may be made a matter of public record. fn 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 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 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. [fn 8]

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*]

[*City and State or Country*]

[*Date*]

.53 If there is public distribution fn 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 AS 3305.08) 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 fn 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 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 AS 3305.29. 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 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 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*]

[*City and State or Country*]

[*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 "statutory basis") 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? fn 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 AS 3305.04). AS 3305.09 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 (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 paragraph .04 of AS 2815, *The Meaning of* "*Present Fairly in Conformity with Generally Accepted Accounting Principles*." [Title of AS 2815 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 AS 3305.02 states that the standards of the PCAOB apply when an auditor conducts an audit of and reports on financial statements prepared on an other comprehensive basis of accounting. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

.63 *Question*—What types of items or matters should auditors consider in evaluating whether informative disclosures are reasonably adequate?

.64 *Interpretation*—AS 3305.09 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. AS 3305.10 also states that when "the 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." [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 "similar informative disclosures" 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. AS 3305.22 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 AS 3101.35–.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 AS 3305.22–.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 AS 3101.35–.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*—AS 3305.10, 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, AS 3305.10 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 AS 3305.10 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.]

Footnotes (AI 24—Special Reports: Auditing Interpretations of AS 3305):

[fn *] [Footnote deleted.]

[fns 3–4] [Footnote deleted.]

fn 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.

fn 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.

fn 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.

[fn 8] [Footnote deleted.]

fn 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.

fn 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 AS 3101, *Reports on Audited Financial Statements*.

fn 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.]

General Auditing Standards

Audit Procedures

Auditor Reporting

Matters Relating to Filings Under Federal Securities Laws

Other Matters Associated with Audits

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AI 25: Association with Financial Statements: Auditing Interpretations of AS 3320

COMMENT ▼ TOOLS ▼

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 AS 4105, *Reviews of Interim Financial Information*, 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 Listiing 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*—Paragraph .04 of AS 3101, *Reports on Audited Financial Statements*, 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." Paragraph .03 of AS 3320, *Association with Financial Statements*, 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*—AS 3320 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*—AS 3320 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.

.21 PCAOB Rules establish requirements regarding auditor independence.

.22 AS 3320.10 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. fn 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.]

Footnotes (AI 25—Association with Financial Statements: Auditing Interpretations of AS 3320):

fn 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.

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AI 26: Responsibilities Regarding Filings Under Federal Securities Statutes: Auditing Interpretations of AS 4101

COMMENT ▼ TOOLS ▼

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 Paragraph .05 of AS 4101, *Responsibilities Regarding Filings Under Federal Securities Statutes*, 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 AS 4101.10 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 AS 4101.10 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, **fn 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. fn 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 paragraph .08 of AS 3315, *Reporting on Condensed Financial Statements and Selected Financial Data*.) 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 AS 4101.10 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 AS 4101 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 AS 4101.10 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. AS 4101.12 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. fn 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.

.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.]

Footnotes (AI 26—Responsibilities Regarding Filings Under Federal Securities Statutes: Auditing Interpretations of AS 4101):

fn 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.

fn 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.

fn 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.

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AI 27: Letters for Underwriters and Certain Other Requesting Parties: Auditing Interpretations of AS 6101

COMMENT ▼ TOOLS ▼

1. Letters to Directors Relating to Annual Reports on Form K [fn *]

.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? [fn 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 paragraph .33 of AS 6101, *Letters for Underwriters and Certain Other Requesting Parties*). fn 2

.04 The auditor may affirm to the board of directors that under the standards of the PCAOB 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 AS 2710, *Other Information in Documents Containing Audited Financial Statements*). 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 AS 6101 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 AS 6101.54-.60 would also be applicable when the auditor is asked to furnish a letter to the board of directors in connection with the filing of Form 10-K under the Securities Exchange Act of 1934. fn 3 The types of information on which auditors may comment are described in AS 6101.55. The auditor should comment only on that information if the criteria in AS 6101.55 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 AS 6101.57 are met. AS 6101.57 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 AS 6101.57.)

.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 AS 6101.55, 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 AS 6101.31.

[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.]

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 "market-risk-sensitive instruments."

.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*—AS 6101.57, 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*—AS 6101.55 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, AS 6101.55 also states that "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." 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 “sensitivity” 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 AS 6101.64, 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**
Ö	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.)

Ä 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 fn 4	19X3 fn 4	19X4 fn 4	19X5 fn 4	There-after fn 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% fn 4	

Interest Rate Derivatives				($US equivalent in millions)			
Interest Rate Swaps:							
Variable to Fixed ($US)	$XXX	$XXX	$XXX	$XXX	$XXX	$XXX	$XXX
Average pay rate-fixed	XX%	XX%	XX%	XX%	XX%	XX%	
Average receive rate-variable	XX%	XX%	XX%	XX%	XX%	XX% fn 4	
Fixed to Variable ($US)	XXX	XXX	XXX	XXX	XXX	XXX	XXX

Average pay rate-variable	XX%	XX%	XX%	XX%	XX%	XX% fn 4
Average receive rate-fixed	XX%	XX%	XX%	XX%	XX%	XX%

[Issue Date: August, 1998.]

Footnotes (AI 27—Letters for Underwriters and Certain Other Requesting Parties: Auditing Interpretations of AS 6101):

[fn *] [Footnote deleted June 1993, by the issuance of Statement on Auditing Standards No. 72.]

[fn 1] [Footnote deleted June 1993, by the issuance of Statement on Auditing Standards No. 72.]

fn 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.

fn 3 AS 6101.12 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."

fn 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 AS 6101.55.

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AI 28: Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations

COMMENT ▼ TOOLS ▼

[.01–.05]

[Paragraphs deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.10 The auditing standards require 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 AS 2810, *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. Paragraph .24 of AS 3101, *Reports on Audited Financial Statements*, 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, AS 2805, *Management Representations*, requires the auditor to obtain written representations from management. AS 2805.06 states that specific representations should relate to the following matters, "availability of all financial records and related data," and AS 2805.08 states that a materiality limit does not apply to that representation. AS 2805.13 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?

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.12 *Interpretation*—Audit documentation is the written 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.13 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 AS 1210, *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?

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.17 *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 AS 1210.01 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 AS 2505, *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?

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.21 *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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.22 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.

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

.23 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.

[.24–.41]

[Paragraphs deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]

Footnotes (AI 28—Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations):

[fns 1—3] ***[Footnotes deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004. For audits of fiscal years beginning before December 15, 2010, click here]***

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Auditing Standard No. 16

[The following appendix was effective for audits of fiscal years ending before June 1, 2014. See PCAOB Release No. 2013-007 for audits of fiscal years ending on or after June 1, 2014, or return to the current version.]

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

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Auditing Standard No. 16 Footnote 27

COMMENT ▼ TOOLS ▼

[The following footnote was effective for audits of fiscal years ending before June 1, 2014. See PCAOB Release No. 2013-008 for audits of fiscal years ending on or after June 1, 2014, or return to the current version.]

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*.

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AS No. 9 Paragraph 6c

COMMENT ▼ TOOLS ▼

[The following subparagraph was effective for audits of fiscal years beginning on or after December 15, 2010. It was amended, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004.

Return to the current version.]

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

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AS No. 9 Footnote 4

COMMENT ▼ TOOLS ▼

[The following footnote was effective for audits of fiscal years beginning on or after December 15, 2010. It was deleted, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004.

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4/ AU sec. 310, *Appointment of the Independent Auditor.*

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AS No. 9 Footnote 7

COMMENT ▼ TOOLS ▼

[The following footnote was effective for audits of fiscal years beginning on or after December 15, 2010. It was amended, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004.

Return to the current version.]

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.

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Auditing Standard No. 5 Paragraph 3

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for fiscal years ending on or after November 15, 2007. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

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.

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Auditing Standard No. 5 Paragraph 9

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for fiscal years ending on or after November 15, 2007. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

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;
- 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.

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Auditing Standard No. 5 Paragraph 15

COMMENT ▼ TOOLS ▼

[The following standard was effective for fiscal years ending on or after November 15, 2007. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

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 sec. 316.44 and .45.

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Auditing Standard No. 5 Paragraph 36

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for fiscal years ending on or after November 15, 2007. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

36. The auditor also should understand how IT affects the company's flow of transactions. The auditor should apply paragraphs .16 through .20, .30 through .32, and .77 through .79, of AU sec. 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.

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

Auditing Standard No. 5 Paragraph 51

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for fiscal years ending on or after November 15, 2007. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

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.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS No. 5 Paragraph 80

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for fiscal years ending on or after November 15, 2007. It was amended, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004.

Return to the current version.]

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.

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS No. 5 Paragraph 81

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for fiscal years ending on or after November 15, 2007. It was amended, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004.

Return to the current version.]

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.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

Auditing Standard No. 5 Paragraph 89

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for fiscal years ending on or after November 15, 2007. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

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.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

Auditing Standard No. 5 Paragraph C6

COMMENT ▼ TOOLS ▼

[The following note was effective for fiscal years ending on or after November 15, 2007. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

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.

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

Auditing Standard No. 5 Footnote 10

COMMENT ▼ TOOLS ▼

[The following footnote was effective for fiscal years ending on or after November 15, 2007. It was amended, effective for audits of fiscal periods beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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10/ See paragraphs .19 through .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.

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Auditing Standard No. 5 Footnote 11

COMMENT ▼ TOOLS ▼

[The following footnote was effective for fiscal years ending on or after November 15, 2007. It was amended, effective for audits of fiscal periods beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

11/ See AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, which provides additional explanation of materiality.

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Auditing Standard No. 5 Footnote 12

COMMENT ▼ TOOLS ▼

[The following footnote was effective for fiscal years ending on or after November 15, 2007. It was amended, effective for audits of fiscal periods beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

12/ See AU sec. 326, *Evidential Matter*, which provides additional information on financial statement assertions.

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

Auditing Standard No. 5 Footnote 13

COMMENT ▼ TOOLS ▼

[The following footnote was effective for fiscal years ending on or after November 15, 2007. It was amended, effective for audits of fiscal periods beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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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 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).

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AS No. 13 Paragraph 5 note

COMMENT ▼ TOOLS ▼

[The following note was effective for audits of fiscal years beginning on or after December 15, 2010. It was deleted, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004.

Return to the current version.]

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.

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AU 329 Title

COMMENT ▼ TOOLS ▼

[The following title was effective for audits of financial statements for periods beginning on or after January 1, 1989. It was amended effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

AU Section 329

Analytical Procedures

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 329.01

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after January 1, 1989. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.01

This section provides guidance on the use of analytical procedures and requires the use of analytical procedures in the planning and overall review stages of all audits.

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AU 329.03

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after January 1, 1989. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.03

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. Accordingly, the identification of the relationships and types of data used, as well as conclusions reached when recorded amounts are compared to expectations, requires judgment by the auditor.

AU 329.04

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after January 1, 1989. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.04

Analytical procedures are used for the following purposes:

a. To assist the auditor in planning the nature, timing, and extent of other auditing procedures

b. As a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions

c. As an overall review of the financial information in the final review stage of the audit

Analytical procedures should be applied to some extent for the purposes referred to in (*a*) and (*c*) above for all audits of financial statements made in accordance with generally accepted auditing standards. In addition, in some cases, analytical procedures can be more effective or efficient than tests of details for achieving particular substantive testing objectives.

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AU 329.06-08

COMMENT ▼ TOOLS ▼

[The following paragraphs were effective for audits of financial statements for periods beginning on or after January 1, 1989. They were deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

Analytical Procedures in Planning the Audit

.06

The purpose of applying analytical procedures in planning the audit is to assist in planning the nature, timing, and extent of auditing procedures that will be used to obtain evidential matter for specific account balances or classes of transactions. To accomplish this, the analytical procedures used in planning the audit should focus on (*a*) enhancing the auditor's understanding of the client's business and the transactions and events that have occurred since the last audit date, and (*b*) identifying areas that may represent specific risks relevant to the audit. Thus, the objective of the procedures is to identify such things as the existence of unusual transactions and events, and amounts, ratios and trends that might indicate matters that have financial statement and audit planning ramifications.

.07

Analytical procedures used in planning the audit generally use data aggregated at a high level. Furthermore, the sophistication, extent and timing of the procedures, which are based on the auditor's judgment, may vary widely depending on the size and complexity of the client. For some entities, the procedures may consist of reviewing changes in account balances from the prior to the current year using the general ledger or the auditor's preliminary or unadjusted working trial balance. In contrast, for other entities, the procedures might involve an extensive analysis of quarterly financial statements. In both cases, the analytical procedures, combined with the auditor's knowledge of the business, serve as a basis for additional inquiries and effective planning.

.08

Although analytical procedures used in planning the audit often use only financial data, sometimes relevant nonfinancial information is considered as well. For example, number of employees, square footage of selling space, volume of goods produced, and similar information may contribute to accomplishing the purpose of the procedures.

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AU 329.09

COMMENT ▼ TOOLS ▼

[The following paragraph was 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. It was amended, effective for audits of fiscal years beginning December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.09

The auditor's reliance on substantive tests to achieve an audit objective related to a particular assertion **fn 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.

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AU 329.10

COMMENT ▼ TOOLS ▼

[The following paragraph was effectivefor audits of financial statements for periods beginning on or after January 1, 1989. It was amended by PCAOB Auditing Standard No. 2, 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.

Return to the current version.]

AU 329.10

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.

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AU 329.16

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements beginning on or after January 1, 1989. It was amended by PCAOB Auditing Standard No. 2, 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.

Return to the current version]

AU 329.16

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

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AU 329.21

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after January 1, 1989. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.21

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 likely misstatement. **fn 3** In designing such other procedures, the auditor should consider that unexplained differences may indicate an increased risk of material misstatement. (See section 316, *Consideration of Fraud in a Financial Statement Audit*.)

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 329.23

COMMENT ▼ TOOLS ▼

[The following paragraph was deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

Analytical Procedures Used in the Overall Review

.23

The objective of analytical procedures used in the overall review stage of the audit is to assist the auditor in assessing the conclusions reached and in the evaluation of the overall financial statement presentation. A wide variety of analytical procedures may be useful for this purpose. The overall review would generally include reading the financial statements and notes and considering (*a*) the adequacy of evidence gathered in response to unusual or unexpected balances identified in planning the audit or in the course of the audit and (*b*) unusual or unexpected balances or relationships that were not previously identified. Results of an overall review may indicate that additional evidence may be needed. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 96, January 2002.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 329.24

COMMENT ▼ TOOLS ▼

[The following paragraph was deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

Effective Date

.24

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.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 329 Footnote 1

COMMENT ▼ TOOLS ▼

[The following footnote was effective for audits of financial statements for periods beginning on or after January 1, 1989. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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fn 1 Assertions are representations by management that are embodied in financial statement components. See section 326, *Evidential Matter*.

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AU 329 Footnote 2

COMMENT ▼ TOOLS ▼

[The following footnote was effective for audits of financial statements for periods beginning on or after January 1, 1989. It was deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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fn 2 See section 312, *Audit Risk and Materiality in Conducting an Audit*, paragraphs .24 through .26.

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AU 329 Footnote 3

COMMENT ▼ TOOLS ▼

[The following footnote was effective for audits of financial statements for periods beginning on or after January 1, 1989. It was deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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fn 3 See section 312.35.

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AU 330.02

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of fiscal periods ending after June 15, 1992. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.02

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 section 312, *Audit Risk and Materiality in Conducting an Audit*. Guidance on the timing of audit procedures is included in section 313, *Substantive Tests Prior to the Balance-Sheet Date*.

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AU 330.05

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of fiscal periods ending after June 15, 1992. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.05

Section 312 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.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 330.06

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of fiscal periods ending after June 15, 1992. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.06

Confirmation is undertaken to obtain evidence from third parties about financial statement assertions made by management. Section 326, *Evidential Matter*, states that, in general, it is presumed that "When evidential matter can be obtained from independent sources outside an entity, it provides greater assurance of reliability for the purposes of an independent audit than that secured solely within the entity."

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 330.11

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of fiscal periods ending after June 15, 1992. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.11

For the evidence obtained to be competent, 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. Section 326 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

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AU 330.24

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of fiscal periods ending after June 15, 1992. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.24

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 competence 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.

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AU 330.27

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of fiscal periods ending after June 15, 1992. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.27

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 **fn 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 competent evidence.

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AU 350.03

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for periods ended on or after June 25, 1983. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.03

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. The guidance in this section applies equally to nonstatistical and statistical sampling.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 350.04

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for periods ended on or after June 25, 1983. It was deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.04

The third standard of field work states, "Sufficient competent 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." Either approach to audit sampling, when properly applied, can provide sufficient evidential matter.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 350.06

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for periods ended on or after June 25, 1983. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.06

Evaluating the competence of evidential matter is solely a matter of auditing judgment and is not determined by the design and evaluation of an audit sample. 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 competence 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.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 350.08

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for periods ended on or after June 25, 1983. It was deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.08

The uncertainty inherent in applying audit procedures is referred to as audit risk. Audit risk consists of (*a*) the risk (consisting of inherent risk and control risk) that the balance or class and related assertions contain misstatements that could be material to the financial statements when aggregated with misstatements in other balances or classes and (*b*) the risk (detection risk) that the auditor will not detect such misstatement. The risk of these adverse events occurring jointly can be viewed as a function of the respective individual risks. Using professional judgment, the auditor evaluates numerous factors to assess inherent risk and control risk (assessing control risk at less than the maximum level involves performing tests of controls), and performs substantive tests (analytical procedures and test of details of account balances or classes of transactions) to restrict detection risk.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 350.09

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.09

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. [As amended August, 1983, by Statement on Auditing Standards No. 45.] (See section 313.)

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 350.11

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.11

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 (see section 311, *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*). [As amended August, 1983, by Statement on Auditing Standards No. 45.] (See section 313.)

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AU 350.15

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for periods ended on or after June 25, 1983. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.15

Planning involves developing a strategy for conducting an audit of financial statements. For general guidance on planning, see section 311, *Planning and Supervision*.

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AU 350.16

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for periods ended on or after June 25, 1983. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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.16

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 (see section 326, *Evidential Matter).*
- Preliminary judgments about materiality levels.
- 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.

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AU 350.18

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for periods ended on or after June 25, 1983. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.18

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 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 without causing the financial statements to be materially misstated. This maximum monetary misstatement for the balance or class is called *tolerable misstatement* for the sample. Tolerable misstatement is a planning concept and is related to the auditor's preliminary judgments about materiality levels in such a way that tolerable misstatement, combined for the entire audit plan, does not exceed those estimates.

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AU 350.20

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for periods ended on or after June 25, 1983. It was deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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.20

The Appendix illustrates how the auditor may relate the risk of incorrect acceptance for a particular substantive test of details to his assessments of inherent risk, control risk, and the risk that analytical procedures and other relevant substantive tests would fail to detect material misstatement.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 350.21

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for periods ended on or after June 25, 1983. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.21

As discussed in section 326, 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.

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AU 350.23

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for periods ended on or after June 25, 1983. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.23

To determine the number of items to be selected in a sample for a particular substantive test of details, the auditor should consider the tolerable misstatement, the allowable risk of incorrect acceptance, and the characteristics of the population. An auditor applies professional judgment to relate these factors in determining the appropriate sample size. The Appendix illustrates the effect these factors may have on sample size.

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AU 350.25

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for periods ended on or after June 25, 1983. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.25

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 should also consider whether the reasons for his inability to examine the items have implications in relation to his planned assessed level of control risk or his degree of reliance on management representations.

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AU 350.38

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for periods ended on or after June 25, 1983. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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.38

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. An auditor applies professional judgment to relate these factors in determining the appropriate sample size.

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AU 350.39

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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.39

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. Section 319.99 provides guidance applicable to the auditor's use of sampling during interim and remaining periods. [Revised, May 2001, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 94.]

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AU 350.44

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for periods ended on or after June 25, 1983. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.44

In some circumstances the auditor may design a sample that will be used for dual purposes: assessing control risk and testing whether the recorded monetary amount of transactions is correct. 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 procedure over entries in the voucher register may plan a related substantive test at a risk level that anticipates an assessment level of control risk below the maximum. 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 pertinent procedures and monetary misstatements should be evaluated separately using the risk levels applicable for the respective purposes.

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AU 350.45

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for periods ended on or after June 25, 1983. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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.45

As discussed in paragraph .04, either a nonstatistical or statistical approach to audit sampling, when properly applied, can provide sufficient evidential matter.

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 350.48 Item 2

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for periods ended on or after June 25, 1983. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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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. However, the second standard of field work contemplates that ordinarily the assessed level of control risk cannot be sufficiently low to eliminate the need to perform any substantive tests to restrict detection risk for all of the assertions relevant to significant account balances or transactions classes.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 350.48 Item 6

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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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 analytical procedures and other relevant substantive tests, and it cannot be properly considered out of this context. [As amended, effective for audits of financial statements for periods ended after September 30, 1983, by Statement on Auditing Standards No. 45.] (See section 313.)

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 350 Footnote 2

COMMENT ▼ TOOLS ▼

[The following footnote was effective for periods ended on or after June 25, 1983. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

fn 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 section 312, *Audit Risk and Materiality in Conducting an Audit.*

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 350 Footnote 6

COMMENT ▼ TOOLS ▼

[The following footnote was effective for periods ended on or after June 25, 1983. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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fn 6 See section 316A, *Consideration of Fraud in a Financial Statement Audit*, paragraph .34, for a further discussion of the auditor's consideration of differences between the accounting records and the underlying facts and circumstances. This section provides specific guidance on the auditor's consideration of an audit adjustment that is, or may be, fraud.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 350 Footnote 7

COMMENT ▼ TOOLS ▼

[The following footnote was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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fn 7 The auditor often plans to perform tests of controls concurrently with obtaining an understanding of internal control (see section 319.85) 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, May 2001, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 94.]

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 350 Footnote 11

COMMENT ▼ TOOLS ▼

[The following footnote was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

fn 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. [As amended, effective for audits of financial statements for periods ended after September 30, 1983, by Statement on Auditing Standards No. 45.] (See section 313.)

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AU 316.01

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.01

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]" **fn 1** This section establishes standards and provides guidance to auditors in fulfilling that responsibility, as it relates to fraud, in an audit of financial statements conducted in accordance with generally accepted auditing standards (GAAS). **fn 2**

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AU 316.01

COMMENT ▼ TOOLS ▼

[The following note was effective for audits of fiscal years ending on or after November 15, 2004, for accelerated filers. It was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

AU 316.01

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 24-26 of PCAOB Auditing Standard No. 2 regarding fraud considerations, in addition to the fraud consideration set forth in this section.

AU 316.02

[The following paragraph was effective for audits of financial statements for periods beginning on or after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.02

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.)
- *Discussion among engagement personnel regarding the risks of material misstatement due to fraud.* This section requires, as part of planning the audit, that there be a discussion among the audit team members to consider how and where the entity's financial statements might be susceptible to material misstatement due to fraud and to reinforce the importance of adopting an appropriate mindset of professional skepticism. (See paragraphs .14 through .18.)

- *Obtaining the information needed to identify risks of material misstatement due to fraud.* This section requires the auditor to gather information necessary to identify risks of material misstatement due to fraud, by
  - *a.* Inquiring of management and others within the entity about the risks of fraud. (See paragraphs .20 through .27.)
  - *b.* Considering the results of the analytical procedures performed in planning the audit. (See paragraphs .28 through .30.)
  - *c.* Considering fraud risk factors. (See paragraphs .31 through .33, and the Appendix, "Examples of Fraud Risk Factors" [paragraph .85].)
  - *d.* Considering certain other information. (See paragraph .34.)
- *Identifying risks that may result in a material misstatement due to fraud.* This section requires the auditor to use the information gathered to identify risks that may result in a material misstatement due to fraud. (See paragraphs .35 through .42.)
- *Assessing the identified risks after taking into account an evaluation of the entity's programs and controls.* This section requires the auditor to evaluate the entity's programs and controls that address the identified risks of material misstatement due to fraud, and to assess the risks taking into account this evaluation. (See paragraphs .43 through .45.)
- *Responding to the results of the assessment.* This section emphasizes that the auditor's response to the risks of material misstatement due to fraud involves the application of professional skepticism when gathering and evaluating audit evidence. (See paragraph .46 through .49.) The section requires the auditor to respond to the results of the risk assessment in three ways:
  - *a.* 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. (See paragraph .50.)
  - *b.* A response to identified risks that involves the nature, timing, and extent of the auditing procedures to be performed. (See paragraphs .51 through .56.)
  - *c.* A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls. (See paragraphs .57 through .67.)
- *Evaluating audit evidence.* This section requires the auditor to assess the risks of material misstatement due to fraud throughout the audit and to evaluate at the completion of the audit whether the accumulated results of auditing procedures and other observations affect the assessment. (See paragraphs .68 through .74.) It also requires the auditor to consider whether identified misstatements may be indicative of fraud and, if so, directs the auditor to evaluate their implications. (See paragraphs .75 through .78.)
- *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.)

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AU 316.03

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after December 15, 2002. It was deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.03

The requirements and guidance set forth in this section are intended to be integrated into an overall audit process, in a logical manner that is consistent with the requirements and guidance provided in other sections, including section 311, *Planning and Supervision*; section 312, *Audit Risk and Materiality in Conducting an Audit*; and section 319, *Consideration of Internal Control in a Financial Statement Audit*. Even though some requirements and guidance set forth in this section are presented in a manner that suggests a sequential audit process, auditing in fact involves a continuous process of gathering, updating, and analyzing information throughout the audit. Accordingly the sequence of the requirements and guidance in this section may be implemented differently among audit engagements.

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AU 316.13

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.13

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 the risk of material misstatement due to fraud. 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.

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AU 316.14-45

COMMENT ▼ TOOLS ▼

[The following paragraphs were effective for audits of financial statements for periods beginning on or after December 15, 2002. They were deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud

.14

Prior to or in conjunction with the information-gathering procedures described in paragraphs .19 through .34 of this section, members of the audit team should discuss the potential for material misstatement due to fraud. The discussion should include:

- An exchange of ideas or "brainstorming" among the audit team members, including the auditor with final responsibility for the audit, about how and where they believe 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. (See paragraph .15.)

- An emphasis on the importance of maintaining the proper state of mind throughout the audit regarding the potential for material misstatement due to fraud. (See paragraph .16.)

.15

The discussion among the audit team members about the susceptibility of the entity's financial statements to material misstatement due to fraud should include a consideration of the known external and internal factors affecting the entity that might (*a*) create incentives/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. The discussion should occur with an attitude that includes a questioning mind as described in paragraph .16 and, for this purpose, setting aside any prior beliefs the audit team members may have that management is honest and has integrity. In this regard, the discussion should include a consideration of the risk of management override of controls. **fn 8** Finally, the discussion should include how the auditor might respond to the susceptibility of the entity's financial statements to material misstatement due to fraud.

.16

The discussion among the audit team members should emphasize the need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating evidence throughout the audit, as described in paragraph .13. This should lead the audit team members to continually be alert for information or other conditions (such as those presented in paragraph .68) that indicate a material misstatement due to fraud may have occurred. It should also lead audit team members to thoroughly probe the issues, acquire additional evidence as necessary, and consult with other team members and, if appropriate, experts in the firm, rather than rationalize or dismiss information or other conditions that indicate a material misstatement due to fraud may have occurred.

.17

Although professional judgment should be used in determining which audit team members should be included in the discussion, the discussion ordinarily should involve the key members of the audit team. A number of factors will influence the extent of the discussion and how it should occur. For example, if the audit involves more than one location, there could be multiple discussions with team members in differing locations. Another factor to consider in planning the discussions is whether to include specialists assigned to the audit team. For example, if the auditor has determined that a professional possessing information technology skills is needed on the audit team (see section 319.32), it may be useful to include that individual in the discussion.

.18

Communication among the audit team members about the risks of material misstatement due to fraud also should continue throughout the audit—for example, in evaluating the risks of material misstatement due to fraud at or near the completion of the field work. (See paragraph .74 and footnote 28.)

Obtaining the Information Needed to Identify the Risks of Material Misstatement

Due to Fraud

.19

Section 311.06–.08 provides guidance about how the auditor obtains knowledge about the entity's business and the industry in which it operates. In performing that work, information may come to the auditor's attention that should be considered in identifying risks of material misstatement due to fraud. As part of this work, the auditor should perform the following procedures to obtain information that is used (as described in paragraphs .35 through .42) to identify the risks of material misstatement due to fraud:

a. Make inquiries of management and others within the entity to obtain their views about the risks of fraud and how they are addressed. (See paragraphs .20 through .27.)

b. Consider any unusual or unexpected relationships that have been identified in performing analytical procedures in planning the audit. (See paragraphs .28 through .30.)

c. Consider whether one or more fraud risk factors exist. (See paragraphs .31 through .33, and the Appendix [paragraph .85].)

d. Consider other information that may be helpful in the identification of risks of material misstatement due to fraud. (See paragraph .34.)

Making Inquiries of Management and Others Within the Entity About the Risks of Fraud

.20

The auditor should inquire of management about: **fn 9**

- Whether management has knowledge of any fraud or suspected fraud affecting the entity
- Whether management is 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
- Management's understanding about the risks of fraud in the entity, including any specific fraud risks the entity has identified or account balances or classes of transactions for which a risk of fraud may be likely to exist
- Programs and controls **fn 10** the entity has established to mitigate specific fraud risks the entity has identified, or that otherwise help to prevent, deter, and detect fraud, and how management monitors those programs and controls. For examples of programs and controls an entity may implement to prevent, deter, and detect fraud, see the exhibit titled "Management Antifraud Programs and Controls" [paragraph .88] at the end of this section.
- For an entity with multiple locations, (*a*) the nature and extent of monitoring of operating locations or business segments, and (*b*) whether there are particular operating locations or business segments for which a risk of fraud may be more likely to exist
- Whether and how management communicates to employees its views on business practices and ethical behavior

.21

The inquiries of management also should include whether management has reported to the audit committee or others with equivalent authority and responsibility **fn 11** (hereafter referred to as the audit committee) on how the entity's internal control **fn 12** serves to prevent, deter, or detect material misstatements due to fraud.

.22

The auditor also should inquire directly of the audit committee (or at least its chair) regarding the audit committee's views about the risks of fraud and whether the audit committee has knowledge of any fraud or suspected fraud affecting the entity. An entity's audit committee sometimes assumes an active role in oversight of the entity's assessment of the risks of fraud and the programs and controls the entity has established to mitigate these risks. The auditor should obtain an understanding of how the audit committee exercises oversight activities in that area.

.23

For entities that have an internal audit function, the auditor also should inquire of appropriate internal audit personnel about their views about the risks of fraud, whether they have performed any procedures to identify or detect fraud during the year, whether management has satisfactorily responded to any findings resulting from these procedures, and whether the internal auditors have knowledge of any fraud or suspected fraud.

.24

In addition to the inquiries outlined in paragraphs .20 through .23, the auditor should inquire of others within the entity about the existence or suspicion of fraud. The auditor should use professional judgment to determine those others within the entity to whom inquiries should be directed and the extent of such inquiries. In making this determination, the auditor should consider whether others within the entity may be able to provide information that will be helpful to the auditor in identifying risks of material misstatement due to fraud—for example, others who may have additional knowledge about or be able to corroborate risks of fraud identified in the discussions with management (see paragraph .20) or the audit committee (see paragraph .22).

.25

Examples of others within the entity to whom the auditor may wish to direct these inquiries include:

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

.26

The auditor's inquiries of management and others within the entity are important because fraud often is uncovered through information received in response to inquiries. One reason for this is that such inquiries may provide individuals with an opportunity to convey information to the auditor that otherwise might not be communicated. Making inquiries of others within the entity, in addition to management, may be useful in providing the auditor with a perspective that is different from that of individuals involved in the financial reporting process. The responses to these other inquiries might serve to corroborate responses received from management, or alternatively, might provide information regarding the possibility of management override of controls—for example, a response from an employee indicating an unusual change in the way transactions have been processed. In addition, the auditor may obtain information from these inquiries regarding how effectively management has communicated standards of ethical behavior to individuals throughout the organization.

.27

The auditor should be aware when evaluating management's responses to the inquiries discussed in paragraph .20 that management is often in the best position to perpetrate fraud. The auditor should use professional judgment in deciding when it is necessary to corroborate responses to inquiries with other information. However, when responses are inconsistent among inquiries, the auditor should obtain additional audit evidence to resolve the inconsistencies.

Considering the Results of the Analytical Procedures Performed in Planning the Audit

.28

Section 329, *Analytical Procedures*, paragraphs .04 and .06, requires that analytical procedures be performed in planning the audit with an objective of identifying the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have financial statement and audit planning implications. In performing analytical procedures in planning the audit, the auditor develops expectations about plausible relationships that are reasonably expected to exist, based on the auditor's understanding of the entity and its environment. When comparison of those expectations with recorded amounts or ratios developed from recorded amounts yields unusual or unexpected relationships, the auditor should consider those results in identifying the risks of material misstatement due to fraud.

.29

In planning the audit, the auditor also should perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that may indicate a material misstatement due to fraudulent financial reporting. An example of such an analytical procedure that addresses this objective is a comparison of sales volume, as determined from recorded revenue amounts, with production capacity. An excess of sales volume over production capacity may be indicative of recording fictitious sales. As another example, a trend analysis of revenues by month and sales returns by month during and shortly after the reporting period may indicate the existence of undisclosed side agreements with customers to return goods that would preclude revenue recognition. fn 13

.30

Analytical procedures performed during planning may be helpful in identifying the risks of material misstatement due to fraud. However, because such analytical procedures generally use data aggregated at a high level, the results of those analytical procedures provide only a broad initial indication about whether a material misstatement of the financial statements may exist. Accordingly, the results of analytical procedures performed during planning should be considered along with other information gathered by the auditor in identifying the risks of material misstatement due to fraud.

Considering Fraud Risk Factors

.31

Because fraud is usually concealed, material misstatements due to fraud are difficult to detect. Nevertheless, the auditor may identify events or conditions that indicate incentives/pressures to perpetrate fraud, opportunities to carry out the fraud, or attitudes/rationalizations to justify a fraudulent action. Such events or conditions are referred to as "fraud risk factors." Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances where fraud exists.

.32

When obtaining information about the entity and its environment, the auditor should consider whether the information indicates that one or more fraud risk factors are present. The auditor should use professional judgment in determining whether a risk factor is present and should be considered in identifying and assessing the risks of material misstatement due to fraud.

.33

Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are presented in the Appendix [paragraph .85]. These illustrative risk factors are classified based on the three conditions generally present when fraud exists: *incentive/pressure* to perpetrate fraud, an *opportunity* to carry out the fraud, and *attitude/rationalization* to justify the fraudulent action. 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.

Considering Other Information That May Be Helpful in Identifying Risks of Material Misstatement Due to Fraud

.34

The auditor should consider other information that may be helpful in identifying risks of material misstatement due to fraud. Specifically, the discussion among the engagement team members (see paragraphs .14 through .18) may provide information helpful in identifying such risks. In addition, the auditor should consider whether information from the results of (*a*) procedures relating to the acceptance and continuance of clients and engagements **fn 14** and (*b*) reviews of interim financial statements may be relevant in the identification of such risks. Finally, as part of the consideration of audit risk at the individual account balance or class of transaction level (see section 312.24 through .33), the auditor should consider whether identified inherent risks would provide useful information in identifying the risks of material misstatement due to fraud (see paragraph .39).

Identifying Risks That May Result in a Material Misstatement Due to Fraud

Using the Information Gathered to Identify Risk of Material Misstatements Due to Fraud

.35

In identifying risks of material misstatement due to fraud, it is helpful for the auditor to consider the information that has been gathered (see paragraphs .19 through .34) in the context of the three conditions present when a material misstatement due to fraud occurs—that is, incentives/pressures, opportunities, and attitudes/rationalizations (see paragraph .07). However, the auditor should not assume that all three conditions must be observed or evident before concluding that there are identified risks. Although the risk of material misstatement due to fraud may be greatest when all three fraud conditions are observed or evident, the auditor cannot assume that the inability to observe one or two of these conditions means there is no risk of material misstatement due to fraud. In fact, observing that individuals have the requisite attitude to commit fraud, or identifying factors that indicate a likelihood that management or other employees will rationalize committing a fraud, is difficult at best.

.36

In addition, the extent to which each of the three conditions referred to above are present when fraud occurs may vary. In some instances the significance of incentives/pressures may result in a risk of material misstatement due to fraud, apart from the significance of the other two conditions. For example, an incentive/pressure to achieve an earnings level to preclude a loan default, or to "trigger" incentive compensation plan awards, may alone result in a risk of material misstatement due to fraud. In other instances, an easy opportunity to commit the fraud because of a lack of controls may be the dominant condition precipitating the risk of fraud, or an individual's attitude or ability to rationalize unethical actions may be sufficient to motivate that individual to engage in fraud, even in the absence of significant incentives/pressures or opportunities.

.37

The auditor's identification of fraud risks also may be influenced by characteristics such as the size, complexity, and ownership attributes of the entity. For example, in the case of a larger entity, the auditor ordinarily considers factors that generally constrain improper conduct by management, such as the effectiveness of the audit committee and the internal audit function, and the existence and enforcement of a formal code of conduct. In the case of a smaller entity, some or all of these considerations may be inapplicable or less important, and management may have developed a culture that emphasizes the importance of integrity and ethical behavior through oral communication and management by example. Also, the risks of material misstatement due to fraud may vary among operating locations or business segments of an entity, requiring an identification of the risks related to specific geographic areas or business segments, as well as for the entity as a whole. fn 15

.38

The auditor should evaluate whether identified risks of material misstatement due to fraud can be related to specific financial-statement account balances or classes of transactions and related assertions, or whether they relate more pervasively to the financial statements as a whole. Relating the risks of material misstatement due to fraud to the individual accounts, classes of transactions, and assertions will assist the auditor in subsequently designing appropriate auditing procedures.

.39

Certain accounts, classes of transactions, and assertions that have high inherent risk because they involve a high degree of management judgment and subjectivity also may present risks of material misstatement due to fraud because they are susceptible to manipulation by management. For example, liabilities resulting from a restructuring may be deemed to have high inherent risk because of the high degree of subjectivity and management judgment involved in their estimation. Similarly, revenues for software developers may be deemed to have high inherent risk because of the complex accounting principles applicable to the recognition and measurement of software revenue transactions. Assets resulting from investing activities may be deemed to have high inherent risk because of the subjectivity and management judgment involved in estimating fair values of those investments.

.40

In summary, the identification of a risk of material misstatement due to fraud involves the application of professional judgment and includes the consideration of the attributes of the risk, including:

- The *type* of risk that may exist, that is, whether it involves fraudulent financial reporting or misappropriation of assets
- The *significance* of the risk, that is, whether it is of a magnitude that could lead to result in a possible material misstatement of the financial statements
- The *likelihood of the risk, that is, the likelihood that it will result in a material misstatement in the financial statements* ***fn 16*** .
- The *pervasiveness* of the risk, that is, whether the potential risk is pervasive to the financial statements as a whole or specifically related to a particular assertion, account, or class of transactions.

A Presumption That Improper Revenue Recognition Is a Fraud Risk

.41

Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period). Therefore, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition. (See paragraph .54 for examples of auditing procedures related to the risk of improper revenue recognition.) **fn 17**

A Consideration of the Risk of Management Override of Controls

.42

Even if specific risks of material misstatement due to fraud are not identified by the auditor, there is a possibility that management override of controls could occur, and accordingly, the auditor should address that risk (see paragraph .57) apart from any conclusions regarding the existence of more specifically identifiable risks.

Assessing the Identified Risks After Taking Into Account an Evaluation of the Entity's Programs and Controls That Address the Risks

.43

Section 319 requires the auditor to obtain an understanding of each of the five components of internal control sufficient to plan the audit. It also notes that 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, and design substantive tests. Additionally, section 319 notes that controls, whether manual or automated, can be circumvented by collusion of two or more people or inappropriate management override of internal control.

.44

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. **fn 18** These programs and controls may involve (*a*) specific controls designed to mitigate specific risks of fraud—for example, controls to address specific assets susceptible to misappropriation, and (*b*) broader programs designed to prevent, deter, and detect fraud—for example, programs to promote a culture of honesty and ethical behavior. The auditor should consider whether such programs and controls mitigate the identified risks of material misstatement due to fraud or whether specific control deficiencies may exacerbate the risks (see paragraph .80). The exhibit at the end of this section [paragraph .88] discusses examples of programs and controls an entity might implement to create a culture of honesty and ethical behavior, and that help to prevent, deter, and detect fraud.

.45

After the auditor has evaluated whether the entity's programs and controls that address identified risks of material misstatement due to fraud have been suitably designed and placed in operation, the auditor should assess these risks taking into account that evaluation. This assessment should be considered when developing the auditor's response to the identified risks of material misstatement due to fraud (see paragraphs .46 through .67). **fn 19**

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AU 316.46heading

COMMENT ▼ TOOLS ▼

[The following heading was effective for audits of financial statements for periods beginning on or after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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AU 316.46-50

COMMENT ▼ TOOLS ▼

[The following paragraphs were effective for audits of financial statements for periods beginning on or after December 15, 2002. They were deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.46

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. As noted in paragraph .13, professional skepticism is an attitude that includes a critical assessment of the competency and sufficiency of audit evidence. Examples of the application of professional skepticism in response to the risks of material misstatement due to fraud are (*a*) designing additional or different auditing procedures to obtain more reliable evidence in support of specified financial statement account balances, classes of transactions, and related assertions, and (*b*) obtaining additional corroboration of management's explanations or representations concerning material matters, such as through third-party confirmation, the use of a specialist, analytical procedures, examination of documentation from independent sources, or inquiries of others within or outside the entity.

.47

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 (paragraphs .35 through .42) and the entity's programs and controls that address these identified risks (paragraphs .43 through .45).

.48

The auditor responds to risks of material misstatement due to fraud in the following three ways:

a. 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 (see paragraph .50).

b. A response to identified risks involving the nature, timing, and extent of the auditing procedures to be performed (see paragraphs .51 through .56).

c. 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 such override could occur (see paragraphs .57 through .67).

.49

The auditor may conclude that it would not be practicable to design auditing procedures that sufficiently address the risks of material misstatement due to fraud. In that case, withdrawal from the engagement with communication to the appropriate parties may be an appropriate course of action (see paragraph .78).

Overall Responses to the Risk of Material Misstatement

.50

Judgments about the risk of material misstatement due to fraud have an overall effect on how the audit is conducted in the following ways:

- *Assignment of personnel and supervision.* 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 (see section 210, *Training and Proficiency of the Independent Auditor*, paragraph .03). For example, the auditor may respond to an identified risk of material misstatement due to fraud by assigning additional persons with specialized skill and knowledge, such as forensic and information technology (IT) specialists, or by assigning more experienced personnel to the engagement. In addition, the extent of supervision should reflect the risks of material misstatement due to fraud (see section 311.11).
- *Accounting principles.* The auditor should consider management's selection and application of significant accounting principles, particularly those related to subjective measurements and complex transactions. 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. In developing judgments about the quality of such principles (see section 380, *Communication With Audit Committees*, paragraph .11), the auditor should consider whether their collective application indicates a bias that may create such a material misstatement of the financial statements.
- *Predictability of auditing procedures.* The auditor should incorporate an element of unpredictability in the selection

from year to year of auditing procedures to be performed—for example, performing substantive tests of selected account balances and assertions not otherwise tested due to their materiality or risk, adjusting the timing of testing from that otherwise expected, using differing sampling methods, and performing procedures at different locations or at locations on an unannounced basis.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 316.51 Heading

COMMENT ▼ TOOLS ▼

[The following heading was effective for audits of financial statements for periods beginning on or after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

Responses Involving the Nature, Timing, and Extent of Procedures to Be Performed to Address the Identified Risks

General Auditing Standards

Audit Procedures

Auditor Reporting

Matters Relating to Filings Under Federal Securities Laws

Other Matters Associated with Audits

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AU 316.51

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after December 15, 2002. It was deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.51

The auditing procedures performed in response to identified risks of material misstatement due to fraud will vary depending upon the types of risks identified and the account balances, classes of transactions, and related assertions that may be affected. These procedures may involve both substantive tests and tests of the operating effectiveness of the entity's programs and controls. However, because management may have the ability to override controls that otherwise appear to be operating effectively (see paragraph .08), it is unlikely that audit risk can be reduced to an appropriately low level by performing only tests of controls.

+ General Auditing Standards

+ Audit Procedures

+ Auditor Reporting

+ Matters Relating to Filings Under Federal Securities Laws

+ Other Matters Associated with Audits

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AU 316.52

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.52

The auditor's responses to address specifically identified risks of material misstatement due to fraud may include changing the nature, timing, and extent of auditing procedures in the following ways:

- The *nature* of auditing procedures performed may need to be changed to obtain evidence that is more reliable or to obtain additional corroborative information. For example, more evidential matter may be needed from independent sources outside the entity, such as public-record information about the existence and nature of key customers, vendors, or counterparties in a major transaction. Also, physical observation or inspection of certain assets may become more important (see section 326, *Evidential Matter*, paragraphs .15 through .21). Furthermore, the auditor may choose to employ computer-assisted audit techniques to gather more extensive evidence about data contained in significant accounts or electronic transaction files. Finally, inquiry of additional members of management or others may be helpful in identifying issues and corroborating other evidential matter (see paragraphs .24 through .26 and paragraph .53).
- The *timing* of substantive tests may need to be modified. The auditor might conclude that substantive testing

should be performed at or near the end of the reporting period to best address an identified risk of material misstatement due to fraud (see section 313, *Substantive Tests Prior to the Balance-Sheet Date*). That is, the auditor might conclude that, given the risks of intentional misstatement or manipulation, tests to extend audit conclusions from an interim date to the period-end reporting date would not be effective.

In contrast, because an intentional misstatement—for example, a misstatement involving inappropriate revenue recognition—may have been initiated in an interim period, the auditor might elect to apply substantive tests to transactions occurring earlier in or throughout the reporting period.

- The *extent* of the procedures applied should reflect the assessment of the risks of material misstatement due to fraud. For example, increasing sample sizes or performing analytical procedures at a more detailed level may be appropriate (see section 350, *Audit Sampling*, paragraph .23, and section 329). Also, computer-assisted audit techniques may enable more extensive testing of electronic transactions and account files. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.

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AU 316.53

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.53

The following are examples of modification of the nature, timing, and extent of tests in response to identified risks of material misstatements due to fraud.

- 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. fn 20

- Interviewing personnel involved in activities in areas where a risk of material misstatement due to fraud has been identified to obtain their insights about the risk and how controls address the risk (also see paragraph .24).
- 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 risk of material misstatement due to fraud resulting from transactions and activities among these components.

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AU 316.54 Heading

COMMENT ▼ TOOLS ▼

[The following heading was effective for audits of financial statements for periods beginning on or after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

Additional Examples of Responses to Identified Risks of Misstatements Arising From Fraudulent Financial Reporting

AU 316.54

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.54

The following are additional examples of responses to identified risks of material misstatements 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 risk of material misstatement due to fraud 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. **fn 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.
- 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 risk of material misstatement due to fraud 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. **fn 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 risk of material misstatement due to fraud 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 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 risk of material misstatement due to fraud 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.

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AU 316.55 Heading

COMMENT ▼ TOOLS ▼

[The following heading was effective for audits of financial statements for periods beginning on or after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

Examples of Responses to Identified Risks of Misstatements Arising From Misappropriations of Assets

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AU 316.55

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.55

The auditor may have identified a risk of material misstatement due to fraud 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.

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AU 316.56

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.56

The auditor's response to a risk of material misstatement due to fraud relating to misappropriation of assets usually will be directed toward certain account balances. Although some of the audit responses noted in paragraphs .52 through .54 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 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.

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Other Matters Associated with Audits

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AU 316.57 Heading

COMMENT ▼ TOOLS ▼

[The following heading was effective for audits of financial statements for periods beginning on or after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

Responses to Further Address the Risk of Management Override of Controls

+ General Auditing Standards

+ Audit Procedures

+ Auditor Reporting

+ Matters Relating to Filings Under Federal Securities Laws

+ Other Matters Associated with Audits

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AU 316.57

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.57

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, in addition to overall responses (paragraph .50) and responses that address specifically identified risks of material misstatement due to fraud (see paragraphs .51 through .56), the procedures described in paragraphs .58 through .67 should be performed to further address the risk of management override of controls.

+ General Auditing Standards
+ Audit Procedures
+ Auditor Reporting
+ Matters Relating to Filings Under Federal Securities Laws
+ Other Matters Associated with Audits

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AU 316.61

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.61

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 the risk of material misstatement 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 operating effectiveness of those controls. However, even though controls might be implemented and operating effectively, the auditor's procedures for testing journal entries and other adjustments should include the identification and 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 risk of material misstatement due to fraud. The auditor should recognize, however, that inappropriate journal entries and adjustments also might be made to other accounts. In audits of entities that have several locations or components, the auditor should consider the need to select journal entries from locations based on the factors set forth in section 312.18.
- *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.

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AU 316.63

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.63

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 **fn 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. As discussed in section 312.36, the auditor should consider whether differences between estimates best supported by the audit evidence and the estimates included in the financial statements, even if they are individually reasonable, indicate a possible bias on the part of the entity's management, in which case the auditor should reconsider the estimates taken as a whole.

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AU 316 68-78

COMMENT ▼ TOOLS ▼

[The following paragraphs were effective for audits of financial statements for periods beginning on or after December 15, 2002. They were deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

Evaluating Audit Evidence

.68

Assessing risks of material misstatement due to fraud throughout the audit. The auditor's assessment of the risks of material misstatement due to fraud should be ongoing throughout the audit. Conditions may be identified during fieldwork that change or support a judgment regarding the assessment of the risks, such as the following:

- Discrepancies in the accounting records, including:
  - Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy
  - Unsupported or unauthorized balances or transactions
  - Last-minute adjustments that significantly affect financial results
  - Evidence of employees' access to systems and records inconsistent with that necessary to perform their

authorized duties
    - Tips or complaints to the auditor about alleged fraud

- Conflicting or missing evidential matter, including:
    - Missing documents
    - Documents that appear to have been altered **fn 26**
    - Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist
    - Significant unexplained items on reconciliations
    - Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures (See paragraph .72.)
    - Unusual discrepancies between the entity's records and confirmation replies
    - Missing inventory or physical assets of significant magnitude
    - Unavailable or missing electronic evidence, inconsistent with the entity's record retention practices or policies
    - Inability to produce evidence of key systems development and program change testing and implementation activities for current-year system changes and deployments

- Problematic or unusual relationships between the auditor and management, including:
    - Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought **fn 27**
    - Undue time pressures imposed by management to resolve complex or contentious issues
    - Complaints by management about the conduct of the audit or management intimidation of audit team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management
    - Unusual delays by the entity in providing requested information
    - Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques
    - Denial of access to key IT operations staff and facilities, including security, operations, and systems development personnel
    - An unwillingness to add or revise disclosures in the financial statements to make them more complete and transparent

.69

Evaluating whether analytical procedures performed as substantive tests or in the overall review stage of the audit indicate a previously unrecognized risk of material misstatement due to fraud. As discussed in paragraphs .28 through .30, the auditor should consider whether analytical procedures performed in planning the audit result in identifying any unusual or unexpected relationships that should be considered in assessing the risks of material misstatement due to fraud. The auditor also should evaluate whether analytical procedures that were performed as substantive tests or in the overall review stage of the audit (see section 329) indicate a previously unrecognized risk of material misstatement due to fraud.

.70

If not already performed during the overall review stage of the audit, the auditor should perform analytical procedures relating to revenue, as discussed in paragraph .29, through the end of the reporting period.

.71

Determining which particular trends and relationships may indicate a risk of material misstatement due to fraud requires professional judgment. Unusual relationships involving year-end revenue and income often are particularly relevant. These might include, for example, (*a*) uncharacteristically large amounts of income being reported in the last week or two of the reporting period from unusual transactions, as well as (*b*) income that is inconsistent with trends in cash flow from operations.

.72

Some unusual or unexpected analytical relationships may have been identified and may indicate a risk of material misstatement due to fraud because management or employees generally are unable to manipulate certain information to create seemingly normal or expected relationships. Some examples are as follows:

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

.73

The auditor also should consider whether responses to inquiries throughout the audit about analytical relationships have been vague or implausible, or have produced evidence that is inconsistent with other evidential matter accumulated during the audit.

.74

Evaluating the risks of material misstatement due to fraud at or near the completion of fieldwork. At or near the completion of fieldwork, the auditor should evaluate whether the accumulated results of auditing procedures and other observations (for example, conditions and analytical relationships noted in paragraphs .69 through .73) affect the assessment of the risks of material misstatement due to fraud made earlier in the audit. This evaluation primarily is a qualitative matter based on the auditor's judgment. Such an evaluation may provide further insight about the risks of material misstatement due to fraud and whether there is a need to perform additional or different audit procedures. As part of this evaluation, the auditor with final responsibility for the audit should ascertain that there has been appropriate communication with the other audit team members throughout the audit regarding information or conditions indicative of risks of material misstatement due to fraud. **fn 28**

.75

Responding to misstatements that may be the result of fraud. When audit test results identify misstatements in the financial statements, the auditor should consider whether such misstatements may be indicative of fraud. **fn 29** That determination affects the auditor's evaluation of materiality and the related responses necessary as a result of that evaluation. **fn 30**

.76

If the auditor believes that misstatements are or may be the result of fraud, but the effect of the misstatements is not material to the financial statements, the auditor nevertheless should evaluate the implications, especially those dealing with the organizational position of the person(s) involved. For example, fraud involving misappropriations of cash from a small petty cash fund normally would be of little significance to the auditor in assessing the risk of material misstatement due to fraud because both the manner of operating the fund and its size would tend to establish a limit on the amount of potential loss, and the custodianship of such funds normally is entrusted to a nonmanagement employee. **fn 31** Conversely, if the matter involves higher-level management, even though the amount itself is not material to the financial statements, it may be indicative of a more pervasive problem, for example, implications about the integrity of management. **fn 32** In such circumstances, the auditor should reevaluate the assessment of the risk of material misstatement due to fraud and its resulting impact on (*a*) the nature, timing, and extent of the tests of balances or transactions and (*b*) the assessment of the effectiveness of controls if control risk was assessed below the maximum.

.77

If the auditor believes that the misstatement is or may be the result of fraud, and either has determined that the effect could be material to the financial statements or has been unable to evaluate whether the effect is material, the auditor should:

a. Attempt to obtain additional evidential matter to determine whether material fraud has occurred or is likely to have occurred, and, if so, its effect on the financial statements and the auditor's report thereon. **fn 33**

b. Consider the implications for other aspects of the audit (see paragraph .76).

c. Discuss the matter and the approach for further investigation with an appropriate level of management that is at least one level above those involved, and with senior management and the audit committee. **fn 34**

d. If appropriate, suggest that the client consult with legal counsel.

.78

The auditor's consideration of the risks of material misstatement and the results of audit tests may indicate such a significant risk of material misstatement due to fraud that the auditor should consider withdrawing from the engagement and communicating the reasons for withdrawal to the audit committee or others with equivalent authority and responsibility. **fn 35** Whether the auditor concludes that withdrawal from the engagement is appropriate may depend on (*a*) the implications about the integrity of management and (*b*) the diligence and cooperation of management or the board of directors in investigating the circumstances and taking appropriate action. Because of the variety of circumstances that may arise, it is not possible to definitively describe when withdrawal is appropriate. **fn 36** The auditor may wish to consult with legal counsel when considering withdrawal from an engagement.

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 316.79

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004.

Return to the current version.]

.79

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 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.

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AU 316.80

COMMENT ▼ TOOLS ▼

[The following paragraph was 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. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.80

If the auditor, as a result of the assessment of the risks of material misstatement, has identified risks of material misstatement due to fraud 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. **fn 38** (See section 325, "Communications About Control Deficiencies in An Audit of Financial Statements," paragraph 4.). The auditor also should consider whether the absence of or deficiencies in programs and controls to mitigate specific risks of fraud or to otherwise help prevent, deter, and detect fraud (see paragraph .44) represent significant deficiencies that should be communicated to senior management and the audit committee.

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AU 316.81

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of fiscal years beginning on or after December 15, 2010. It was amended, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004.

Return to the current version.]

.81

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 quality of the entity's accounting principles (see section 380.11).

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AU 316.83

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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.83

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 .14 through .17.)
- The procedures performed to obtain information necessary to identify and assess the risks of material misstatement due to fraud (See paragraphs .19 through .34.)
- Specific risks of material misstatement due to fraud that were identified (see paragraphs .35 through .45), and a description of the auditor's response to those risks (See paragraphs .46 through .56.)
- If the auditor has not identified in a particular circumstance, improper revenue recognition as a risk of material misstatement due to fraud, the reasons supporting the auditor's conclusion (See paragraph .41.)
- The results of the procedures performed to further address the risk of management override of controls (See

paragraphs .58 through .67.)

- 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 .68 through .73.)
- The nature of the communications about fraud made to management, the audit committee, and others (See paragraphs .79 through .82.)

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AU 316.84

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after December 15, 2002. It was deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

Effective Date

.84

This section is effective for audits of financial statements for periods beginning on or after December 15, 2002. Early application of the provisions of this section is permissible.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 316.85

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.85

A.1 This appendix contains examples of risk factors discussed in paragraphs .31 through .33 of the section. 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.

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AU 316 Footnote 1

COMMENT ▼ TOOLS ▼

[The following footnote was effective for audits of financial statements for periods beginning on or after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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fn 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 (see section 312, *Audit Risk and Materiality in Conducting an Audit*, or fraud).

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AU 316 Footnote 2

COMMENT ▼ TOOLS ▼

[The following footnote was effective for audits of financial statements for periods beginning on or after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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fn 2 Auditors are sometimes requested to perform other services related to fraud detection and prevention, for example, special investigations to determine the extent of a suspected or detected fraud. These other services usually include procedures that extend beyond or are different from the procedures ordinarily performed in an audit of financial statements in accordance with generally accepted auditing standards (GAAS). AT section 101, *Attest Engagements*, and CS section 100, *Consulting Services: Definitions and Standards*, provide guidance to accountants relating to the performance of such services.

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AU 316 Footnote 5

COMMENT ▼ TOOLS ▼

[The following footnote was effective for audits of financial statements for periods beginning on or after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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fn 5 Reference to generally accepted accounting principles (GAAP) includes, where applicable, a comprehensive basis of accounting other than GAAP as defined in section 623, *Special Reports*, paragraph .04.

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AU 316 Footnotes 8-19

COMMENT ▼ TOOLS ▼

[The following footnotes were effective for audits of financial statements for periods beginning on or after December 15, 2002. They were deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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fn 8 See footnote 6.

fn 9 In addition to these inquiries, section 333, *Management Representations*, requires the auditor to obtain selected written representations from management regarding fraud.

fn 10 Section 319, *Consideration of Internal Control in a Financial Statement Audit*, paragraphs .06 and .07, defines internal control and its five interrelated components (the control environment, risk assessment, control activities, information and communication, and monitoring). Entity programs and controls intended to address the risks of fraud may be part of any of the five components discussed in section 319.

fn 11 Examples of "others with equivalent authority and responsibility" may include the board of directors, the board of trustees, or the owner in an owner-managed entity, as appropriate.

fn 12 See footnote 10.

fn 13 See paragraph .70 for a discussion of the need to update these analytical procedures during the overall review stage of the audit.

fn 14 See Statement on Quality Control Standards (SQCS) No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* [QC section 20.14–.16], as amended.

fn 15 Section 312.18 provides guidance on the auditor's consideration of the extent to which auditing procedures should be performed at selected locations or components.

fn 16 The occurrence of material misstatements of financial statements due to fraud is relatively infrequent in relation to the total population of published financial statements. However, the auditor should not use this as a basis to conclude that one or more risks of a material misstatement due to fraud are not present in a particular entity.

fn 17 For a discussion of indicators of improper revenue recognition and common techniques for overstating revenue and illustrative audit procedures, see the AICPA Audit Guide *Auditing Revenue in Certain Industries*.

fn 18 See footnote 10.

fn 19 Notwithstanding that the auditor assesses identified risks of material misstatement due to fraud, the assessment need not encompass an overall judgment about whether risk for the entity is classified as *high*, *medium*, or *low* because such a judgment is too broad to be useful in developing the auditor's response described in paragraphs .46 through .67.

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AU 316 Footnote 20

COMMENT ▼ TOOLS ▼

[The following footnote was effective for audits of financial statements for periods beginning on or after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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fn 20 Section 329, *Analytical Procedures*, provides guidance on performing analytical procedures as substantive tests.

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AU 316 Footnote 21

COMMENT ▼ TOOLS ▼

[The following footnote was effective for audits of financial statements for periods beginning on or after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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fn 21 Section 330, *The Confirmation Process*, provides guidance about the confirmation process in audits performed in accordance with GAAS.

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AU 316 Footnote 22

COMMENT ▼ TOOLS ▼

[The following footnote was effective for audits of financial statements for periods beginning on or after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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fn 22 Section 336, *Using the Work of a Specialist*, provides guidance to an auditor who uses the work of a specialist in performing an audit in accordance with GAAS.

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AU 316 Foonote 23

COMMENT ▼ TOOLS ▼

[The following footnote was effective for audits of financial statements for periods beginning on or after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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fn 23 Section 319 requires the auditor to obtain an understanding of the automated and manual procedures an entity uses to prepare financial statements and related disclosures, and how misstatements may occur. This understanding includes (*a*) the procedures used to enter transaction totals into the general ledger; (*b*) the procedures used to initiate, record, and process journal entries in the general ledger; and (*c*) other procedures used to record recurring and nonrecurring adjustments to the financial statements.

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AU 316 Footnotes 26-36

COMMENT ▼ TOOLS ▼

[The following footnotes were effective for audits of financial statements for periods beginning on or after December 15, 2002. They were deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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fn 26 As discussed in paragraph .09, auditors are not trained as or expected to be experts in the authentication of documents; however, if the auditor believes that documents may not be authentic, he or she should investigate further and consider using the work of a specialist to determine the authenticity.

fn 27 Denial of access to information may constitute a limitation on the scope of the audit that may require the auditor to consider qualifying or disclaiming an opinion on the financial statements. (See section 508, *Reports on Audited Financial Statements*, paragraph .24.)

fn 28 To accomplish this communication, the auditor with final responsibility for the audit may want to arrange another discussion among audit team members about the risks of material misstatement due to fraud (see paragraphs .14 through .18).

fn 29 See footnote 4.

fn 30 Section 312.34 states in part, "Qualitative considerations also influence the auditor in reaching a conclusion as to whether misstatements are material." Section 312.11 states, "As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements."

fn 31 However, see paragraphs .79 through .82 of this section for a discussion of the auditor's communication responsibilities.

fn 32 Section 312.08 states that there is a distinction between the auditor's response to detected misstatements due to error and those due to fraud. When fraud is detected, the auditor should consider the implications for the integrity of management or employees and the possible effect on other aspects of the audit.

fn 33 See section 508 for guidance on auditors' reports issued in connection with audits of financial statements.

fn 34 If the auditor believes senior management may be involved, discussion of the matter directly with the audit committee may be appropriate.

fn 35 See footnote 11.

fn 36 If the auditor, subsequent to the date of the report on the audited financial statements, becomes aware that facts existed at that date that might have affected the report had the auditor been aware of such facts, the auditor should refer to section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, for guidance. Furthermore, section 315, *Communications Between Predecessor and Successor Auditors*, paragraphs .21 and .22, provide guidance regarding communication with a predecessor auditor.

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AU 317.08

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after January 1, 1989. It was amended, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004.

Return to the current version.]

.08

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 concerning the client's compliance with laws and 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.

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AU 317.13

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after January 1, 1989. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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.13

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, section 312, *Audit Risk and Materiality in Conducting an Audit*, paragraph .11, states that "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."

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AU 317.17

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after January 1, 1989. It was amended, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004.

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.17

The auditor should assure himself that the audit committee, or others with equivalent authority and responsibility, is adequately informed with respect to illegal acts that come to the auditor's attention. **fn 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.

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AU 317.19

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after January 1, 1989. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.19

If the auditor is precluded by the client from obtaining sufficient competent 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.

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AU 317.17_fn1b

COMMENT ▼ TOOLS ▼

[Footnote 1 of paragraph 17 was effective for audits of financial statements for periods beginning on or after January 1, 1989. It was amended, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004.

Return to the current version.]

fn1 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.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 334.09

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for periods ended after September 30, 1983. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.09

After identifying related party transactions, 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. The procedures should be directed toward obtaining and evaluating sufficient competent 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. **fn 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.

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AU 334.11

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for periods ended after September 30, 1983. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.11

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 competent 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. **fn 8**

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 334 Footnote 8

COMMENT ▼ TOOLS ▼

[The following footnote was effective for periods ended after September 30, 1983. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

fn 8 The disclosure standards are contained in FASB Statement No. 57, paragraphs 2 through 4 [AC section R36.102-.104]. Also, see section 431, *Adequacy of Disclosure in Financial Statements*.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 341.02

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of fiscal years ending on or after November 15, 2007. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.02

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 section 326, *Evidential Matter*.

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AU 342.01

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after January 1, 1989. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.01

This section provides guidance to auditors on obtaining and evaluating sufficient competent 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.

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AU 342.07

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after January 1, 1989. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.07

The auditor's objective when evaluating accounting estimates is to obtain sufficient competent 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 **fn 2** and are properly disclosed. **fn 3**

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 342.08

COMMENT ▼ TOOLS ▼

[The following subparagraph was effective for audits of financial statements for periods beginning on or after January 1, 1989. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

- 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 (section 311, *Planning and Supervision*).

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 342.10

COMMENT ▼ TOOLS ▼

[The following subparagraph was effective for audits of financial statements for periods beginning on or after January 1, 1989. It was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

AU 342.10

c. Review subsequent events or transactions occurring prior to completion of fieldwork.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 342.13

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after January 1, 1989. It was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to current version.]

AU 342.13

Review subsequent events or transactions. Events or transactions sometimes occur subsequent to the date of the balance sheet, but prior to the completion of fieldwork, 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.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 342.14

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after January 1, 1989. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.14

As discussed in section 312, *Audit Risk and Materiality in Conducting an Audit*, paragraph .36, the auditor evaluates the reasonableness of accounting estimates in relationship to the financial statements taken as a whole:

> Since no one accounting estimate can be considered accurate with certainty, the auditor recognizes that a difference between an estimated amount best supported by the audit evidence and the estimated amount included in the financial statements may be reasonable, and such difference would not be considered to be a likely misstatement. However, if the auditor believes the estimated amount included in the financial statements is unreasonable, he should treat the difference between that estimate and the closest reasonable estimate as a likely misstatement and aggregate it with other likely misstatements. The auditor should also consider whether the difference between estimates best supported by the audit evidence and the estimates included in the financial statements, which are individually reasonable, indicate a possible bias on the part of the entity's management. For example, if each

accounting estimate included in the financial statements was individually reasonable, but the effect of the difference between each estimate and the estimate best supported by the audit evidence was to increase income, the auditor should reconsider the estimates taken as a whole.

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 342_fn3

COMMENT ▼ TOOLS ▼

[The following footnote was effective for audits of financial statements for periods beginning on or after January 1, 1989. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

fn 3 Section 431, *Adequacy of Disclosure in Financial Statements*, discusses the auditor's responsibility to consider whether the financial statements include adequate disclosures of material matters in light of the circumstances and facts of which he is aware.

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AU 328.03

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after June 15, 2003. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.03

The auditor should obtain sufficient competent 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." **fn 1** Although GAAP may not prescribe the 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.

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AU 328.11

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after June 15, 2003. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.11

Section 319, *Consideration of Internal Control in a Financial Statement Audit*, as amended, 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.

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AU 328.14

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after June 15, 2003. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.14

Section 319 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 (see section 316, *Consideration of Fraud in a Financial Statement Audit*. The auditor considers the inherent limitations of internal control in such circumstances in assessing control risk.

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AU 328.25

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after June 15, 2003. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.25

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 competent 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 competent 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.

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AU 328.32

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after June 15, 2003. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.32

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 competent 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.

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AU 328.41

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after June 15, 2003. It was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current verson.]

AU 328.41

Events and transactions that occur after the balance-sheet date but before completion of fieldwork (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. **fn 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.

Footnotes (AU Section 328 — Auditing Fair Value Measurements and Disclosures):

fn 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*.

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AU 328.42

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after June 15, 2003. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.42

Some subsequent events or transactions may reflect changes in circumstances occurring after the balance-sheet date and thus do not constitute competent 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.

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AU 328.44

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after June 15, 2003. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.44

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 competent 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.

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 328.47

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after June 15, 2003. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.47

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 section 312, *Audit Risk and Materiality in Conducting an Audit*, paragraphs .36 through .41).

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AU 328.50

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after June 15, 2003. It was amended, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004.

Return to the current version.]

.50

Section 380, *Communication With Audit Committees*, requires auditors to determine that certain matters related to the conduct of an audit are communicated to audit committees. Certain 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. The auditor should determine that the audit committee is 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. For example, the auditor considers communicating the nature of significant assumptions used in fair value measurements, the degree of subjectivity involved in the development of the assumptions, and the relative materiality of the items being measured at fair value to the financial statements as a whole. The auditor considers the guidance contained in section 380 when determining the nature and form of communication.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 328 Footnote 4

COMMENT ▼ TOOLS ▼

[The following footnote was effective for audits of financial statements for periods beginning on or after June 15, 2003. It was amended by the Board in PCAOB Release 2008-001 (January 29, 2008), effective November 15, 2008.

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AU 328 FOOTNOTE 4

fn 4 Paragraph 16 of Accounting Principles Board Opinion No. 20, Accounting Changes, states that the presumption that an entity should not change an accounting principle may be overcome only if the entity justifies the use of an alternative acceptable accounting principle on the basis that it is preferable.

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AU 328 Footnote 8

COMMENT ▼ TOOLS ▼

[The following footnote was effective for audits of financial statements for periods beginning on or after June 15, 2003. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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fn 8 See also section 431, *Adequacy of Disclosure in Financial Statements*.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 332.01

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for fiscal years ending on or after June 30, 2001. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.01

This section provides guidance to auditors in planning and performing auditing procedures for assertions about derivative instruments, hedging activities, and investments in securities **fn 2** that are made in an entity's financial statements. **fn 3** Those assertions **fn 4** are classified according to five broad categories that are discussed in section 326, *Evidential Matter*, paragraphs .03–.08, and address the following:

a. Existence or occurrence

b. Completeness

c. Rights and obligations

d. Valuation or allocation

e. Presentation and disclosure

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 332.06

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for fiscal years ending on or after June 30, 2001. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.06

The auditor may plan to seek the assistance of employees of the auditor's firm, or others outside the firm, with the necessary skill or knowledge. Section 311, *Planning and Supervision*, provides guidance on the use of individuals who serve as members of the audit team and assist the auditor in planning and performing auditing procedures. The auditor also may plan to use the work of a specialist. Section 336, *Using the Work of a Specialist*, provides guidance on the use of the work of specialists as evidential matter.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 332.07

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for fiscal years ending on or after June 30, 2001. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.07

Section 312, *Audit Risk and Materiality in Conducting an Audit*, provides guidance on the auditor's consideration of audit risk and materiality when planning and performing an audit of financial statements in accordance with generally accepted auditing standards. It requires the auditor to design procedures to obtain reasonable assurance of detecting misstatements of assertions about derivatives and securities that, when aggregated with misstatements of other assertions, could cause the financial statements taken as a whole to be materially misstated. When designing such procedures, the auditor should consider the inherent risk and control risk for these 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*.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 332.09

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.09

Section 319, *Consideration of Internal Control in a Financial Statement Audit*, 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.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 332.11

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.11

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. Section 319.47 defines the information system as the procedures, whether automated or manual, and records established by an entity to initiate, record, process, and report entity transactions and to maintain accountability for the related assets, liabilities, and equity. 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.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 332.11

COMMENT ▼ TOOLS ▼

[The following note was effective for audits of fiscal years ending on or after November 15, 2004, for accelerated filers. It was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

AU 332.11

Note: When performing an integrated audit of financial statements and internal control over financial reporting, PCAOB Auditing Standard No. 2 states, "the auditor must obtain sufficient competent evidence about the design and operating effectiveness of controls over all relevant financial statement assertions related to all significant accounts and disclosures in the financial statements." Therefore, in an integrated audit of financial statements and internal control over financial reporting, if a company's investment in derivatives and securities represents a significant account, 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.

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 332.15

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for fiscal years ending on or after June 30, 2001. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.15

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 section 319.

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 332.35

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for fiscal years ending on or after June 30, 2001. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.35

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 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, section 312.36, provides guidance on considering a difference between an estimated amount best supported by the audit evidence and the estimated amount included in the financial statements.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 332.43

COMMENT ▼ TOOLS ▼

[The following subparagraph was effective for audits of financial statements for fiscal years ending on or after June 30, 2001. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

a. Section 342 on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates.

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 332.51

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for fiscal years ending on or after June 30, 2001. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.51

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. However, the auditor should also follow the guidance in section 431, *Adequacy of Disclosure in Financial Statements*, in evaluating the adequacy of disclosure that is not specifically required by generally accepted accounting principles.

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 332.57c

COMMENT ▼ TOOLS ▼

[The following subparagraph was effective for audits of financial statements for fiscal years ending on or after June 30, 2001. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

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 competent 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.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 324.01

COMMENT ▼ TOOLS ▼

[The following note was effective for audits of fiscal years ending on or after November 15, 2004, for accelerated filers. It was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

AU 324.01

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs B18-B29 of Appendix B, "Additional Performance Requirements and Directions; Extent-of-Testing Examples," in PCAOB Auditing Standard No. 2 regarding the use of service organizations.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 324.07

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.07

Section 319, *Consideration of Internal Control in a Financial Statement Audit*, 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.

[As amended, effective for service auditor's reports covering descriptions as of or after January 1, 1997, by Statement on Auditing Standards No. 78. As amended, effective December 1999, by Statement on Auditing Standards No. 88.

Revised, May 2001, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 94.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 324.16

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.16

The guidance in section 319.90 through .99, 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.]

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 324.20

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for service auditor's reports dated after March 31, 1993. It was amended by PCAOB Auditing Standard No. 2, 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.

Return to the current version.]

AU 324.20

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 reportable conditions. In such circumstances, the user auditor should consider the guidance provided in section 325, Communication of Internal Control Related Matters Noted in an Audit.

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 324.23

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for service auditors' reports dated after March 31, 1993. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.23

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 section 312, *Audit Risk and Materiality in Conducting an Audit*, 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.

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 322.01

COMMENT ▼ TOOLS ▼

[The following note was effective for audits of fiscal years ending on or after November 15, 2004, for accelerated filers. It was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

AU 322.01

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 108-126 of PCAOB Auditing Standard No. 2 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.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 322.02

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods ending after December 15, 1991. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.02

One of the auditor's responsibilities in an audit conducted in accordance with generally accepted auditing standards is to obtain sufficient competent 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. **fn 2**

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 322.16

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of periods ending after December 15, 1991. It was amended by PCAOB Auditing Standard No. 2, 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.

Return to the current version.]

Account-Balance or Class-of-Transaction Level

AU 322.16

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 significant assertions 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.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 322.18

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods ending after December 15, 1991. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.18

Even though the internal auditors' work may affect the auditor's procedures, the auditor should perform procedures to obtain sufficient, competent, 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. **fn 5**

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 322.20

COMMENT ▼ TOOLS ▼

[The following note was effective for audits of fiscal years ending on or after November 15, 2004, for accelerated filers. It was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

AU 322.20

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 112-116 of PCAOB Auditing Standard No. 2 regarding evaluating the nature of controls subjected to the work of others.

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 322.22

COMMENT ▼ TOOLS ▼

[The following note was effective for audits of fiscal years ending on or after November 15, 2004, for accelerated filers. It was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

AU 322.22

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 122 of PCAOB Auditing Standard No. 2 regarding assessing the interrelationship of the nature of the controls and the competence and objectivity of those who performed the work.

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 322 Footnote 3

COMMENT ▼ TOOLS ▼

[The following footnote was effective for audits of financial statements for periods ending after December 15, 1991. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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fn 3 Section 319, *Consideration of Internal Control in a Financial Statement Audit*, describes the procedures the auditor follows to obtain an understanding of internal control and indicates that the internal audit function is part of the entity's control environment.

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 322 Footnote 5

COMMENT ▼ TOOLS ▼

[The following footnote was effective for audits of financial statements for periods ending after December 15, 1991. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

fn 5 See section 326, *Evidential Matter*, paragraph .19c.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 322 Footnote 8

COMMENT ▼ TOOLS ▼

[The following footnote was effective for audits of financial statements for periods ending after December 15, 1991. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

fn 8 See section 311, *Planning and Supervision*, paragraphs .11 through .14, for the type of supervisory procedures to apply.

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 315.12

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.12

The successor auditor must obtain sufficient competent 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 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, **fn 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. [As amended, effective for audits of financial statements for periods ending on or after June 30, 2001, by Statement on Auditing Standards No. 93.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 315.16

COMMENT ▼ TOOLS ▼

[The following paragraph was effective with respect to acceptance of an engagement after March 31, 1998. It was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

AU 315.16

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 section 336, *Using the Work of a Specialist*, or an internal auditor as defined in section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 315.18

COMMENT ▼ TOOLS ▼

[The following paragraph was effective with respect to acceptance of an engagement after March 31, 1998. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.18

If, in a reaudit engagement, the successor auditor is unable to obtain sufficient competent 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.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU Section 558

[The following paragraph was effective for audits of fiscal years ending before June 1, 2014. See PCAOB Release No. 2013-008 for audits of fiscal years ending on or after June 1, 2014, or return to the current version.]

.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 **fn4**—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.]

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fn4 Client-prepared documents include financial reports prepared by the client but merely reproduced by the auditor on the client's behalf.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU Section 558

COMMENT ▼ TOOLS ▼

[The following footnote was effective for audits of fiscal years ending before June 1, 2014. See PCAOB Release No. 2013-008 for audits of fiscal years ending on or after June 1, 2014, or return to the current version.]

fn3 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.

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AU Section 558

COMMENT ▼ TOOLS ▼

[The following footnote was effective for audits of fiscal years ending before June 1, 2014. See PCAOB Release No. 2013-008 for audits of fiscal years ending on or after June 1, 2014, or return to the current version.]

fn7 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.]

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU Section 550

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of fiscal years ending before June 1, 2014. See PCAOB Release No. 2013-008 for audits of fiscal years ending on or after June 1, 2014, or return to the current version.]

.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 **fn †** and 711 **fn ††**). Also, this section is not applicable to other information on which the auditor is engaged to express an opinion. **fn 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 **fn *** and 623 **fn ****).

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fn †[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.)

fn †† [Section number revised, April 1981, by the issuance of Statement on Auditing Standards No. 37.] (See section

711.)

fn 1 Mere reading of other information is an inadequate basis for expressing an opinion on that information.

fn * [Section number revised, July 1980, by the issuance of Statement on Auditing Standards No. 29.] (See section 551.)

fn ** [Section number changed, April 1989, by the issuance of Statement on Auditing Standards No. 62.] (See section 623.)

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AU 550.04

COMMENT ▼ TOOLS ▼

[The following paragraph was issued December 1975. It was amended, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004.

Return to the current version.]

.04

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 statements. **fn 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 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.

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 550.06

COMMENT ▼ TOOLS ▼

[The following paragraph was issued December 1975. It was amended, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004.

Return to the current version.]

.06

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 consider steps such as notifying his client in writing of his views concerning the information and consulting his legal counsel as to further appropriate action in the circumstances.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU Section 550

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of fiscal years ending before June 1, 2014. See PCAOB Release No. 2013-008 for audits of fiscal years ending on or after June 1, 2014, or return to the current version.]

.07 If certain other information **fn 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.]

fn 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.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU Section 550

COMMENT ▼ TOOLS ▼

[The following footnote was effective for audits of fiscal years ending before June 1, 2014. See PCAOB Release No. 2013-008 for audits of fiscal years ending on or after June 1, 2014, or return to the current version.]

fn * [Section number revised, July 1980, by the issuance of Statement on Auditing Standards No. 29.] (See section 551.)

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AU 560.01

COMMENT ▼ TOOLS ▼

[The following note was effective for audits of fiscal years ending on or after November 15, 2004, for accelerated filers. It was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

AU 560.01

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 186-189 of PCAOB Auditing Standard No. 2, which provide direction with respect to subsequent events in an audit of internal control over financial reporting.

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In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 560.12

COMMENT ▼ TOOLS ▼

[The following paragraph was issued in November 1972. It was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

AU 560.12

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 completion of the field work. The auditor generally should:

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 333.05

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods beginning on or after June 30, 1998. It was amended, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004.

Return to the current version.]

.05

Written representations from management should be obtained for all financial statements and periods covered by the auditor's report. **fn 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.

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AU 333.05

COMMENT ▼ TOOLS ▼

[The following note was effective for audits of fiscal years ending on or after November 15, 2004, for accelerated filers. It was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

AU 333.05

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 142-144 of PCAOB Auditing Standard No. 2 for additional required written representations to be obtained from management.

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AU 333.09

COMMENT ▼ TOOLS ▼

The following paragraph was effective for audits of financial statements for periods ending on or after June 30, 1998. It was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to current version.]

AU 333.09

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 a date no earlier than 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.

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AU 333 Footnote 4

COMMENT ▼ TOOLS ▼

[The following footnote was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

fn 4 Section 312, *Audit Risk and Materiality in Conducting an Audit*, paragraph .04, states that a misstatement can result from errors or fraud, and provides guidance for the auditor's evaluation of audit findings (section 312.34-.40). [Footnote added, effective for audits of financial statements for periods beginning on or after December 15, 1999, by Statement on Auditing Standards No. 89.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 333 Footnote 6

COMMENT ▼ TOOLS ▼

[The following footnote was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

fn 6 Section 312 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 added, effective for audits of financial statements for periods beginning on or after December 15, 1999, by Statement on Auditing Standards No. 89.]

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 333 Footnote 7

COMMENT ▼ TOOLS ▼

[The following footnote was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

fn 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 .38 through .40. The auditor may have additional communication responsibilities pursuant to section 317, Section 10A of the Securities Exchange Act of 1934, or section 316. [Footnote added, effective for audits of financial statements for periods beginning on or after December 15, 1999, by Statement on Auditing Standards No. 89. Footnote renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 411.01

COMMENT ▼ TOOLS ▼

[The following paragraph was amended by the Board in PCAOB Release 2008-001 (January 29, 2008), effective November 15, 2008.

Return to the current version.]

.01

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 . . . in conformity with generally accepted accounting principles." [As amended, effective for reports issued or reissued on or after June 30, 2001 by Statement on Auditing Standards No. 93.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 411.02

COMMENT ▼ TOOLS ▼

[The following paragraph was deleted pursuant to PCAOB Release 2008-001 (January 29, 2008), effective November 15, 2008.

Return to the current version.]

.02

The first standard of reporting requires an auditor who has audited financial statements in accordance with generally accepted auditing standards to state in the auditor's report whether the statements are presented in conformity with generally accepted accounting principles. The phrase "generally accepted accounting principles" is a technical accounting term that encompasses the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. It includes not only broad guidelines of general application, but also detailed practices and procedures. Those conventions, rules, and procedures provide a standard by which to measure financial presentations. [Revised, June 1993, to reflect conforming changes necessary due to the issuance of Statement of Position 93-3.]

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 411.04

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of financial statements for periods ending after March 15, 1992. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.04

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 section 431); (*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 section 431); 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. **fn 1**

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AU 411.05

COMMENT ▼ TOOLS ▼

[The following paragraph was deleted pursuant to PCAOB Release 2008-001 (January 29, 2008), effective November 15, 2008.

Return to current version.]

.05

Independent auditors agree on the existence of a body of generally accepted accounting principles, and they are knowledgeable about these principles and in the determination of their general acceptance. Nevertheless, the determination that a particular accounting principle is generally accepted may be difficult because no single reference source exists for all such principles. The sources of established accounting principles that are generally accepted in the United States of America are—

a. Accounting principles promulgated by a body designated by the AICPA Council to establish such principles, pursuant to rule 203 [ET section 203.01] of the AICPA Code of Professional Conduct. Rule 203 [ET section 203.01] provides that an auditor should not express an unqualified opinion if the financial statements contain a material departure from such pronouncements unless, due to unusual circumstances, adherence to the pronouncements would make the statements misleading. Rule 203 [ET section 203.01] implies that application of officially established accounting principles almost always results in the fair presentation of financial position, results of operations, and cash flows, in conformity with generally accepted accounting principles. Nevertheless, rule 203 [ET section 203.01] provides for the possibility that literal application of such a pronouncement might, in unusual circumstances, result in misleading financial statements. (See section 508, *Reports on Audited Financial Statements*, paragraphs .14 and .15.)

b. Pronouncements of bodies, composed of expert accountants, that deliberate accounting issues in public forums for the purpose of establishing accounting principles or describing existing accounting practices that are generally accepted, provided those pronouncements have been exposed for public comment and have been cleared by a body referred to in category (*a*). **fn 2**

c. Pronouncements of bodies, organized by a body referred to in category (a) and composed of expert accountants, that deliberate accounting issues in public forums for the purpose of interpreting or establishing accounting principles or describing existing accounting practices that are generally accepted, or pronouncements referred to in category (*b*) that have been cleared by a body referred to in category (*a*) but have not been exposed for public comment.

d. Practices or pronouncements that are widely recognized as being generally accepted because they represent prevalent practice in a particular industry, or the knowledgeable application to specific circumstances of pronouncements that are generally accepted.

[Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

Footnotes (AU Section 411 — The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles):

fn 2 For purposes of this section, the word cleared means that a body referred to in subparagraphs (*a*) has indicated that it does not object to the issuance of the proposed pronouncement.

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In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 411.07

COMMENT ▼ TOOLS ▼

The following paragraph was effective for audits of financial statements for periods ending after March 15, 1992. It was deleted pursuant to PCAOB Release 2008-001 (January 29, 2008), effective November 15, 2008.

Return to current version.]

.07

If the accounting treatment of a transaction or event is not specified by a pronouncement covered by rule 203 [ET section 203.01], the auditor should consider whether the accounting treatment is specified by another source of established accounting principles. If an established accounting principle from one or more sources in category (*b*), (*c*), or (*d*) is relevant to the circumstances, the auditor should be prepared to justify a conclusion that another treatment is generally accepted. If there is a conflict between accounting principles relevant to the circumstances from one or more sources in category (*b*), (*c*), or (*d*), the auditor should follow the treatment specified by the source in the higher category—for example, follow category (*b*) treatment over category (*c*)—or be prepared to justify a conclusion that a treatment specified by a source in the lower category better presents the substance of the transaction in the circumstances.

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In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 411.09

COMMENT ▼ TOOLS ▼

The following paragraphs were effective for audits of financial statements for periods ending after March 15, 1992. They were deleted pursuant to PCAOB Release 2008-001 (January 29, 2008), effective November 15, 2008.

Return to current version.]

.09

Because of developments such as new legislation or the evolution of a new type of business transaction, there sometimes are no established accounting principles for reporting a specific transaction or event. In those instances, it might be possible to report the event or transaction on the basis of its substance by selecting an accounting principle that appears appropriate when applied in a manner similar to the application of an established principle to an analogous transaction or event.

Application to Nongovernmental Entities

.10

For financial statements of entities other than governmental entities— **fn 3**

a. Category (*a*), officially established accounting principles, consists of Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards and Interpretations, Accounting Principles Board (APB) Opinions, and AICPA Accounting Research Bulletins.

b. Category (*b*) consists of FASB Technical Bulletins and, if cleared **fn 4** by the FASB, AICPA Industry Audit and Accounting Guides and AICPA Statements of Position.

c. Category (*c*) consists of AICPA Accounting Standards Executive Committee (AcSEC) Practice Bulletins that have been cleared **fn 4** by the FASB and consensus positions of the FASB Emerging Issues Task Force.

d. Category (*d*) includes AICPA accounting interpretations and implementation guides ("Qs and As") published by the FASB staff, and practices that are widely recognized and prevalent either generally or in the industry.

The following paragraph was deleted pursuant to PCAOB Release 2008-001 (January 29, 2008), effective November 15, 2008.

Return to current version.]

.11

In the absence of a pronouncement covered by rule 203 [ET section 203.01] or another source of established accounting principles, the auditor of financial statements of entities other than governmental entities may consider other accounting literature, depending on its relevance in the circumstances. Other accounting literature includes, for example, FASB Statements of Financial Accounting Concepts; AICPA Issues Papers; International Accounting Standards of the International Accounting Standards Committee; Governmental Accounting Standards Board (GASB) Statements, Interpretations, and Technical Bulletins; Federal Accounting Standards Advisory Board (FASAB) Statements, Interpretations, and Technical Bulletins; pronouncements of other professional associations or regulatory agencies; Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids; and accounting textbooks, handbooks, and articles. The appropriateness of other accounting literature depends on its relevance to particular circumstances, the specificity of the guidance, and the general recognition of the issuer or author as an authority. For example, FASB Statements of Financial Accounting Concepts would normally be more influential than other sources in this category. [Revised, June 1993, to reflect conforming changes necessary due to the issuance of Statement of Position 93-3.]

Application to State and Local Governmental Entities

The following paragraph was effective for audits of financial statements for periods ending after March 15, 1992. It was *deleted pursuant to PCAOB Release 2008-001 (January 29, 2008), effective November 15, 2008.*

Return to current version.]

.12

For financial statements of state and local governmental entities— **fn 5**

a. Category (*a*), officially established accounting principles, consists of GASB Statements and Interpretations, as well as AICPA and FASB pronouncements specifically made applicable to state and local governmental entities by GASB Statements or Interpretations. GASB Statements and Interpretations are periodically incorporated in the *Codification of Governmental Accounting and Financial Reporting Standards*.

b. Category (*b*) consists of GASB Technical Bulletins and, if specifically made applicable to state and local governmental entities by the AICPA and cleared **fn 6** by the GASB, AICPA Industry Audit and Accounting Guides and AICPA Statements of Position.

c. Category (*c*) consists of AICPA AcSEC Practice Bulletins if specifically made applicable to state and local governmental entities and cleared **fn 6** by the GASB, as well as consensus positions of a group of accountants organized by the GASB that attempts to reach consensus positions on accounting issues applicable to state and local governmental entities. **fn 7**

d. Category (*d*) includes implementation guides ("Qs and As") published by the GASB staff, as well as practices that are widely recognized and prevalent in state and local government.

[The following paragraphs were deleted pursuant to PCAOB Release 2008-001 (January 29, 2008), effective November 15, 2008.

Return to current version.]

.13

In the absence of a pronouncement covered by rule 203 [ET section 203.01] or another source of established accounting principles, the auditor of financial statements of state and local governmental entities may consider other accounting literature, depending on its relevance in the circumstances. Other accounting literature includes, for example, GASB Concepts Statements; the pronouncements referred to in categories (*a*) through (*d*) of paragraph .10 when not specifically made applicable to state and local governmental entities either by the GASB or by the organization issuing them; FASB Concepts Statements; FASAB Statements, Interpretations, Technical Bulletins, and Concepts Statements; AICPA Issues Papers; International Accounting Standards of the International Accounting Standards Committee; pronouncements of other professional associations or regulatory agencies; Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids; and accounting textbooks, handbooks, and articles. The appropriateness of other accounting literature depends on its relevance to particular circumstances, the specificity of the guidance, and the general recognition of the issuer or author as an authority. For example, GASB Concepts Statements would normally be more influential than other sources in this category. [Revised, June 1993, to reflect conforming changes necessary due to the issuance of Statement of Position 93-3.]

Application to Federal Governmental Entities

.14

For financial statements of federal governmental entities— **fn 8**

a. Category (*a*), officially established accounting principles, consists of Federal Accounting Standards Advisory Board (FASAB) Statements and Interpretations, as well as AICPA and FASB pronouncements specifically made applicable to federal governmental entities by FASAB Statements or Interpretations. FASAB Statements and Interpretations will be periodically incorporated in a publication by the FASAB.

b. Category (*b*) consists of FASAB Technical Bulletins and, if specifically made applicable to federal governmental entities by the AICPA and cleared by the FASAB, AICPA Industry Audit and Accounting Guides and AICPA Statements of Position. **fn 9**

c. Category (*c*) consists of AICPA AcSEC Practice Bulletins if specifically made applicable to federal governmental entities and cleared by the FASAB, as well as Technical Releases of the Accounting and Auditing Policy Committee of the FASAB.

d. Category (*d*) includes implementation guides published by the FASAB staff, as well as practices that are widely recognized and prevalent in the federal government.

[Paragraph added, effective April 2000, by Statement on Auditing Standards No. 91.]

.15

In the absence of a pronouncement covered by rule 203 [ET section 203.01] or another source of established accounting principles, the auditor of financial statements of a federal governmental entity may consider other accounting literature, depending on its relevance in the circumstances. Other accounting literature includes, for example, FASAB Concepts Statements; the pronouncements referred to in categories (*a*) through (*d*) of paragraph .10 when not specifically made applicable to federal governmental entities by the FASAB; FASB Concepts Statements; GASB Statements, Interpretations, Technical Bulletins, and Concepts Statements; AICPA Issues Papers; International Accounting Standards of the International Accounting Standards Committee; pronouncements of other professional associations or regulatory agencies; Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids; and accounting textbooks, handbooks, and articles. The appropriateness of other accounting literature depends on its relevance to particular circumstances, the specificity of the guidance, and the general recognition of the issuer or author as an authority. For example, FASAB Concepts Statements would normally be more influential than other sources in this category. [Paragraph added, effective April 2000, by Statement on Auditing Standards No. 91.]

Effective Date

.16

This section is effective for audits of financial statements for periods ending after March 15, 1992. [Paragraph renumbered by the issuance of Statements on Auditing Standards No. 91, April 2000.]

Transition

.17

Most of the pronouncements or practices in categories *(b)*, *(c)*, and *(d)* of paragraphs .10 and .12 had equal authoritative standing prior to the issuance of this section. An entity following an accounting treatment in category *(c)* or *(d)* as of March 15, 1992, need not change to an accounting treatment in a category *(b)* or category *(c)* pronouncement whose effective date is before March 15, 1992. For example, a nongovernmental entity that followed a prevalent industry practice (category *(d)*) as of March 15, 1992, need not change to an accounting treatment included in a pronouncement in category *(b)* or *(c)* (for example, an accounting principle in a cleared AICPA statement of Position or AcSEC Practice Bulletin) whose effective date is before March 15, 1992. For pronouncements whose effective date is subsequent to March 15, 1992, and for entities initially applying an accounting principle after March 15, 1992 (except for FASB Emerging Issues Task Force consensus positions issued before March 16, 1992, which become effective in the hierarchy for initial application of an accounting principle after March 15, 1993), the auditor should follow the applicable hierarchy established by paragraphs .10 and .12 in determining whether an entity's financial statements are fairly presented in conformity with generally accepted accounting principles. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 91, April 2000.]

GAAP Hierarchy Summary fn †

.18

Nongovernmental Entities	*State and Local Governments*	*Federal Governmental Entities*
	Established Accounting Principles	
.10*a* FASB Statements and Interpretations APB Opinions, and AICPA Accounting	.12*a* GASB Statements and Interpretations plus AICPA and FASB pronouncements if made	.14*a* FASAB Statements and Interpretations plus AICPA and FASB pronouncements if made

Research Bulletins	applicable to state and local governments by a GASB Statement or Interpretation	applicable to federal governmental entities by a FASAB Statement or Interpretation
.10*b* FASB Technical Bulletins AICPA Industry Audit and Accounting Guides, and AICPA Statements of Position	.12*b* GASB Technical Bulletins, and the following pronouncements if specifically made applicable to state and local governments by the AICPA: AICPA Industry Audit and Accounting Guides and AICPA Statements of Position	.14*b* FASAB Technical Bulletins and the following pronouncements if specifically made applicable to federal governmental entities by the AICPA and cleared by the FASAB: AICPA Industry Audit and Accounting Guides and AICPA Statements of Position
.10*c* Consensus positions of the FASB Emerging Issues Task Force and AICPA Practice Bulletins	.12*c* Consensus positions of the GASB Emerging Issues Task Force fn ‡ and AICPA Practice Bulletins if specifically made applicable to state and local governments by the AICPA	.14*c* AICPA AcSEC Practice Bulletins if specifically made applicable to federal governmental entities and cleared by the FASAB and Technical Releases of the Accounting and Auditing Policy Committee of the FASAB
.10*d* AICPA accounting interpretations, "Qs and As" published by the FASB staff, as well as industry practices widely recognized and prevalent	.12*d* "Qs and As" published by the GASB staff, as well as industry practices widely recognized and prevalent	.14*d* Implementation guides published by the FASAB staff and practices that are widely recognized and prevalent in the federal government
	Other Accounting Literature fn ||	
.11 Other accounting literature, including FASB Concepts Statements; AICPA Issues Papers; International Accounting Standards Committee Statements; GASB Statements, Interpretations, and Technical Bulletins; FASAB Statements, Interpretations, and Technical Bulletins; pronouncements of other professional associations or regulatory agencies; AICPA	.13 Other accounting literature, including GASB Concepts Statements; pronouncements in categories (*a*) through (*d*) of the hierarchy for nongovernmental entities when not specifically made applicable to state and local governments; FASB Concepts Statements; FASAB Statements, Interpretations, and Technical Bulletins, and Concepts Statements; AICPA	.15 Other accounting literature, including FASAB Concepts Statements; pronouncements in categories (*a*) through (*d*) of the hierarchy in paragraph .10 when not specifically made applicable to federal governmental entities; FASB Concepts Statements; GASB Statements, Interpretations, Technical Bulletins, and Concepts Statements; AICPA Issues

Technical Practice Aids, and accounting textbooks, handbooks, and articles	Issues Papers; International Accounting Standards Committee Statements; pronouncements of other professional associations or regulatory agencies; AICPA *Technical Practice Aids*; and accounting textbooks, handbooks, and articles	Papers; International Accounting Standards of the International Accounting Standards Committee; pronouncements of other professional associations or regulatory agencies; AICPA *Technical Practice Aids*; and accounting textbooks, handbooks, and articles

[Revised, June 1993, to reflect conforming changes necessary due to the issuance of Statement of Position 93-3. Paragraph renumbered and amended, effective April 2000, by Statement on Auditing Standards No. 91.]

Footnotes (AU Section 411 — The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles):

fn 3 Rules and interpretive releases of the Securities and Exchange Commission (SEC) have an authority similar to category (*a*) pronouncements for SEC registrants. In addition, the SEC staff issues Staff Accounting Bulletins that represent practices followed by the staff in administering SEC disclosure requirements. Also, the Introduction to the FASB's *EITF Abstracts* states that the Securities and Exchange Commission's Chief Accountant has said that the SEC staff would challenge any accounting that differs from a consensus of the FASB Emerging Issues Task Force, because the consensus position represents the best thinking on areas for which there are no specific standards.

fn 4 The auditor should assume that such pronouncements have been cleared by the FASB unless the pronouncement indicates otherwise.

fn 5 State and local governmental entities include public benefit corporations and authorities; public employee retirement systems; and governmental utilities, hospitals and other health care providers, and colleges and universities.

fn 6 The auditor should assume that such pronouncements specifically made applicable to state and local governments have been cleared by the GASB unless the pronouncement indicates otherwise.

fn 7 As of the date of this section, the GASB had not organized such a group.

fn 8 Federal Accounting Standards Advisory Board (FASAB) Concepts Statement No. 2, *Entity and Display*, defines federal governmental entities. [Footnote added, effective April 2000, by Statement on Auditing Standards No. 91.]

fn 9 The auditor should assume that such pronouncements specifically made applicable to federal governmental entities have been cleared by the FASAB, unless the pronouncement indicates otherwise. [Footnote added, effective April 2000, by Statement on Auditing Standards No. 91.]

fn † Paragraph references correspond to the paragraphs of this section that describe the categories of the GAAP hierarchy.

fn ‡ As of the date of this section, the GASB had not organized such a group.

fn || In the absence of established accounting principles, the auditor may consider other accounting literature, depending on its relevance in the circumstances.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 411 Footnote 1

COMMENT ▼ TOOLS ▼

[The following footnote was effective for audits of financial statements for periods ending after March 15, 1992. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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fn 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, 312.10, and 508.36). [Footnotes 2-9 deleted]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

Auditing Standard No. 6 Paragraph 10

COMMENT ▼ TOOLS ▼

[The following paragraph was effective November 15, 2008. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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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.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

Auditing Standard No. 6 Footnote 3

COMMENT ▼ TOOLS ▼

[The following footnote was effective November 15, 2008. It was deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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3/ The term "error," as used in SFAS No. 154, is equivalent to "misstatement," as used in the auditing standards.

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 561.01

COMMENT ▼ TOOLS ▼

[The following note was 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. It was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

AU 561.01

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 197 of PCAOB Auditing Standard No. 2, 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.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 561 Footnote 3

COMMENT ▼ TOOLS ▼

[The following footnote was amended by the Board in PCAOB Release 2008-001 (January 29, 2008), effective November 15, 2008.

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Footnotes (AU Section 561 — Subsequent Discovery of Facts Existing at the Date of the Auditor's Report):

fn 3 See paragraphs 26 and 27 of Accounting Principles Board Opinion No. 9 [AC section A35.107–.108] and paragraphs 36 and 37 of Opinion No. 20 [AC section A35.105] regarding disclosure of adjustments applicable to prior periods. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 98, September 2002.]

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In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 508.01

COMMENT ▼ TOOLS ▼

[The following note was effective for audits of fiscal years ending on or after November 15, 2004, for accelerated filers. It was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

AU 508.01

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 162-199 of PCAOB Auditing Standard No. 2 for direction on reporting on internal control over financial reporting. 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.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 508.03

[The following paragraph was effective for reports issued or reissued on or after January 1, 1989. It was amended by the Board in PCAOB Release 2008-001 (January 29, 2008), effective November 15, 2008.

To return to current version.]

.03

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. **fn 2** This section is concerned primarily with the relationship of the fourth reporting standard to the language of the auditor's report.

Footnotes (AU Section 508 — Reports on Audited Financial Statements):

fn 2 This section revises the second standard of reporting as follows: 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. Previously, the second standard required the auditor's report to state whether accounting principles had been consistently applied. As revised, the second standard requires the auditor to add an explanatory paragraph to his report only if accounting principles have not been applied consistently. (See section 420, *Consistency of Application of Generally Accepted Accounting Principles*.) Paragraphs .17-.19 of this section provide reporting guidance under these circumstances.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 508.11

COMMENT ▼ TOOLS ▼

.11

Certain circumstances, while not affecting the auditor's unqualified opinion, may require that the auditor add an explanatory **fn 10** These circumstances include:

a. The auditor's opinion is based in part on the report of another auditor (paragraphs .12 and .13).

[The following item was deleted pursuant to PCAOB Release 2008-001 (January 29, 2008), effective November 15, 2008.

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b. To prevent the financial statements from being misleading because of unusual circumstances, the financial statements contain a departure from an accounting principle promulgated by a body designated by the AICPA Council to establish such principles (paragraphs .14 and .15).

[Items c. and d. were renumbered by the Board in PCAOB Release 2008-001 (January 29, 2008), effective November 15, 2008.

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c. There is substantial doubt about the entity's ability to continue as a going concern. **fn 11** *d.* There has been a material change between periods in accounting principles or in the method of their application (paragraphs .16 through .18).

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 on Auditing Standards No. 79. Revised, November 2002, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 100.]

Footnotes (AU Section 508 — Reports on Audited Financial Statements):

fn 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.]

fn 10 See footnote 3. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

fn 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.]

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AU 508.14

COMMENT ▼ TOOLS ▼

[The following paragraphs and note were effective for reports issued or reissued on or after January 1, 1989. They were deleted pursuant to PCAOB Release 2008-001 (January 29, 2008), effective November 15, 2008.

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Departure From a Promulgated Accounting Principle

.14

Rule 203 [ET section 203.01] of the Code of Professional Conduct of the AICPA states:

> A member shall not (1) express an opinion or state affirmatively that the financial statements or other financial data of any entity are presented in conformity with generally accepted accounting principles or (2) state that he or she is not aware of any material modifications that should be made to such statements or data in order for them to be in conformity with generally accepted accounting principles, if such statements or data contain any departure from an accounting principle promulgated by bodies designated by Council to establish such principles that has a material effect on the statements or data taken as a whole. If, however, the statements or data contain such a departure and the member can demonstrate that due to unusual circumstances the financial statements or data would otherwise

have been misleading, the member can comply with the rule by describing the departure, its approximate effects, if practicable, and the reasons why compliance with the principle would result in a misleading statement.

.15

When the circumstances contemplated by Rule 203 [ET section 203.01] are present, the auditor's report should include, in a separate paragraph or paragraphs, the information required by the rule. In such a case, it is appropriate for the auditor to express an unqualified opinion with respect to the conformity of the financial statements with generally accepted accounting principles unless there are other reasons, not associated with the departure from a promulgated principle, not to do so. (See section 411, The Meaning of Present Fairly in 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.]

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.

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 508.16

COMMENT ▼ TOOLS ▼

[The following paragraph was amended by the Board in PCAOB Release 2008-001 (January 29, 2008), effective November 15, 2008.

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.16

The auditor's standard report implies that the auditor is satisfied that the comparability of financial statements between periods has not been materially affected by changes in accounting principles and that such principles have been consistently applied between or among periods because either (*a*) no change in accounting principles has occurred, or (b) there has been a change in accounting principles or in the method of their application, but the effect of the change on the comparability of the financial statements is not material. In these cases, the auditor should not refer to consistency in the report. If, however, there has been a change in accounting principles or in the method of their application that has a material effect on the comparability of the company's financial statements, the auditor should refer to the change in an explanatory paragraph of the report. Such explanatory paragraph (following the opinion paragraph) should identify the nature of the change and refer the reader to the note in the financial statements that discusses the change in detail. The auditor's concurrence with a change is implicit unless he or she takes exception to the change in expressing his or her opinion as to fair presentation of the financial statements in conformity with generally accepted accounting principles. **fn 12** When there is a change in accounting principles, there are also other matters that the auditor should consider (see paragraphs .50 through .57). [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

Footnotes (AU Section 508 — Reports on Audited Financial Statements):

fn 12 With respect to the method of accounting for the effect of a change in accounting principle, see Accounting Principles Board Opinion No. 20, *Accounting Changes*, including paragraph 4 [AC section A06.103], which states that methods of accounting for changes in principles resulting from the implementation of new pronouncements is provided in those pronouncements. [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.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 508.17

COMMENT ▼ TOOLS ▼

[The following paragraph was amended by the Board in PCAOB Release 2008-001 (January 29, 2008), effective November 15, 2008.

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.17

Following is an example of an appropriate explanatory paragraph:

As discussed in Note X to the financial statements, the Company changed its method of computing depreciation in 20X2.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 508.18

COMMENT ▼ TOOLS ▼

[The following paragraph was amended by the Board in PCAOB Release 2008-001 (January 29, 2008), effective November 15, 2008.

Return to the current version.]

.18

The addition of this explanatory paragraph in the auditor's report is required in reports on financial statements of subsequent years as long as the year of the change is presented and reported on. **fn 13** However, if the accounting change is accounted for by retroactive restatement of the financial statements affected, the additional paragraph is required only in the year of the change since, in subsequent years, all periods presented will be comparable. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

Footnotes (AU Section 508 — Reports on Audited Financial Statements):

fn 13 An exception to this requirement occurs when a change in accounting principle that does not require a cumulative effect adjustment is made at the beginning of the earliest year presented and reported on. That exception is addressed in the auditing interpretation of section 420, *Consistency of Application of Generally Accepted Accounting Principles*, titled "Impact on the Auditor's Report of FIFO to LIFO Change in Comparative Financial Statements," (section 9420.16-.23). [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.]

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 508.18C

COMMENT ▼ TOOLS ▼

[The following paragraph was effective November 15, 2008. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.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.

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AU 508.20

COMMENT ▼ TOOLS ▼

[The following subparagraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

a. There is a lack of sufficient competent 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).

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AU 508.22

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.22

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 competent 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.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 508.24

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.24

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. **fn 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 competent 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.]

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AU 508.49

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.49

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 section 312, *Audit Risk and Materiality*, and section 342, *Auditing Accounting Estimates*) 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. [Paragraph added, effective for reports issued or reissued on or after February 29, 1996, by Statement on Auditing Standards No. 79.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 508.50

COMMENT ▼ TOOLS ▼

[The following paragraph was deleted pursuant to PCAOB Release 2008-001 (January 29, 2008), effective November 15, 2008.

Return to the current version.]

.50

Accounting changes. The auditor should evaluate a change in accounting principle to satisfy himself that (*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, and (*c*) management's justification for the change is reasonable. If a change in accounting principle does not meet these conditions, the auditor's report should so indicate, and his opinion should be appropriately qualified as discussed in paragraphs .51 and .52. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 508.51

COMMENT ▼ TOOLS ▼

[The following paragraph was amended by the Board in PCAOB Release 2008-001 (January 29, 2008), effective November 15, 2008.

Return to the current version.]

.51

If (*a*) a newly adopted accounting principle is not a generally accepted accounting principle, (*b*) the method of accounting for the effect of the change is not in conformity with generally accepted accounting principles, or (*c*) management has not provided reasonable justification for the change in accounting principle, the auditor should express a qualified opinion or, if the effect of the change is sufficiently material, the auditor should express an adverse opinion on the financial statements. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 508.52

COMMENT ▼ TOOLS ▼

[The following paragraph was amended by the Board in PCAOB Release 2008-001 (January 29, 2008), effective November 15, 2008.

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.52

Accounting Principles Board Opinion No. 20, Accounting Changes, paragraph 16 [AC section A06.112], states: "The presumption that an entity should not change an accounting principle may be overcome only if the enterprise justifies the use of an alternative acceptable accounting principle on the basis that it is preferable." If management has not provided reasonable justification for the change in accounting principles, the auditor should express an exception to the change having been made without reasonable justification. An example of a report qualified for this reason follows:

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 for making this change as required by those principles. fn 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.]

Footnotes (AU Section 508 — Reports on Audited Financial Statements):

fn 17 Section 420, *Consistency of Application of Generally Accepted Accounting Principles*, states that a change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error and that such a change requires recognition in the auditor's report as to consistency. Therefore, the auditor should add an explanatory paragraph to the report discussing the accounting change. However, because the middle 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 .16 through .18 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.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 508.57

COMMENT ▼ TOOLS ▼

[The following paragraph was amended by the Board in PCAOB Release 2008-001 (January 29, 2008), effective November 15, 2008.

Return to the current version.]

.57

If management has not provided reasonable justification for a change in accounting principles, the auditor's opinion should express an exception to the change having been made without reasonable justification, as previously indicated. In addition, the auditor should continue to express his or her exception with respect to the financial statements for the year of change as long as they are presented and reported on. However, the auditor's exception relates to the accounting change and does not affect the status of a newly adopted principle as a generally accepted accounting principle. Accordingly, while expressing an exception for the year of change, the independent auditor's opinion regarding the subsequent years' statements need not express an exception to use of the newly adopted principle. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

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AU 508.63

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.63

An example of a report disclaiming an opinion resulting from an inability to obtain sufficient competent 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. **fn 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.]

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AU 508.66

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.66

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 section 431, *Adequacy of Disclosure in Financial Statements*, and ARB No. 43, Chapter 2A [AC section F43].) 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.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 508.69

COMMENT ▼ TOOLS ▼

[The following paragraph was amended by the Board in PCAOB Release 2008-001 (January 29, 2008), effective November 15, 2008.

Return to the current version.]

.69

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*) the circumstances or events that caused the auditor to express a different opinion, and (*d*) 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 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. **fn 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.]

Footnotes (AU Section 508 — Reports on Audited Financial Statements):

fn 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.]

fn 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.]

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AU 508.73

COMMENT ▼ TOOLS ▼

[The following paragraph was amended by the Board in PCAOB Release 2008-001 (January 29, 2008), effective November 15, 2008.

Return to the current version.]

.73

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 restated, 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.]

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AU 508.74

COMMENT ▼ TOOLS ▼

[The following paragraph was amended by the Board in PCAOB Release 2008-001 (January 29, 2008), effective November 15, 2008.

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.74

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, **fn 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. **fn 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 restated, the introductory paragraph should indicate that a predecessor auditor reported on the financial statements of the prior period before restatement. 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 restatement adjustments, he or she may also include the following paragraph in his 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.

[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.]

Footnotes (AU Section 508 — Reports on Audited Financial Statements):

fn 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.]

fn 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.]

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AU 508 Footnote 15

COMMENT ▼ TOOLS ▼

[The following footnote was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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fn 15 Section 431, *Adequacy of Disclosure in the Financial Statements*, defines *practicable* as ". . . 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. [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.]

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AU 508 Footnote 19

COMMENT ▼ TOOLS ▼

[The following footnote was amended by the Board in PCAOB Release 2008-001 (January 29, 2008), effective November 15, 2008.

Return to the current version.]

Footnotes (AU Section 508 — Reports on Audited Financial Statements):

fn 19 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 (*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.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 508 Footnote 20

COMMENT ▼ TOOLS ▼

[The following footnote was amended by the Board in PCAOB Release 2008-001 (January 29, 2008), effective November 15, 2008.

Return to the current version.]

Footnotes (AU Section 508 — Reports on Audited Financial Statements):

fn 20 If an accountant is engaged to conduct an audit of the financial statements of a nonpublic entity in accordance with generally accepted auditing standards, but is requested to change the engagement to a review or a compilation of the statements, he or she should look to the guidance in paragraphs 46 through 51 of Statement on Standards for Accounting and Review Services No. 1, *Compilation and Review of Financial Statements* [AR section 100.46-.51]. 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.]*

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AU 508 Footnote 25

COMMENT ▼ TOOLS ▼

[The following footnote was amended by the Board in PCAOB Release 2008-001 (January 29, 2008), effective November 15, 2008.

Return to current version.]

Footnotes (AU Section 508 — Reports on Audited Financial Statements):

fn 25 It is assumed that the independent auditor has been able to satisfy himself or herself as to the consistency of application of generally accepted accounting principles. See section 420, *Consistency of Application of Generally Accepted Accounting Principles*, 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.]

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AU 530.01

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of fiscal years ending on or after November 15, 2007. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.01

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.

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AU 530.05

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of fiscal years ending on or after November 15, 2007. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.05

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.

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AU Section 530

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of fiscal years ending before June 1, 2014. See PCAOB Release No. 2013-008 for audits of fiscal years ending on or after June 1, 2014, or return to the current version.]

.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 fn * 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.)

fn * Section number revised, April 1981, by the issuance of Statement on Auditing Standards No. 37.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU Section 552

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of fiscal years ending before June 1, 2014. See PCAOB Release No. 2013-008 for audits of fiscal years ending on or after June 1, 2014, or return to the current version.]

.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 **fn 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*.

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fn 1 *Public entity* is defined in section 504, *Association With Financial Statements*, footnote 2.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 711.02

COMMENT ▼ TOOLS ▼

[The following note was effective for audits of fiscal years ending on or after November 15, 2004, for accelerated filers. It was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the to current version.]

AU 711.02

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 198-199 of PCAOB Auditing Standard No. 2, 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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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 711.10

COMMENT ▼ TOOLS ▼

[The following paragraph was issued in April 1981. It was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

AU 711.10

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 completion of field work, and, as a practical matter, 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

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AU 711.13

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for interim periods within fiscal years beginning after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004.

Return to the current version.]

.13

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 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.

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AU 722.03

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for interim periods within fiscal years beginning after December 15, 2002. It was amended as a result of the adoption of Auditing Standard No. 5, effective for reviews of interim periods ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

AU 722.03

The Securities and Exchange Commission (SEC) requires **fn 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. 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.

Footnotes (AU Section 722 — Interim Financial Information):

fn 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.

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AU 722.03 Note

COMMENT ▼ TOOLS ▼

[The following note was effective for interim periods within fiscal years beginning after December 15, 2002. It was amended as a result of the adoption of Auditing Standard No. 5, effective for reviews of interim periods ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

AU 722.03

Note: When an auditor is engaged to perform an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 202-206 of PCAOB Auditing Standard No. 2, which provide direction regarding the auditor's evaluation responsibilities as they relate to management's quarterly certifications on internal control over financial reporting.

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AU 722.07

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for interim periods within fiscal years beginning after December 15, 2002. It was amended as a result of the adoption of Auditing Standard No. 5, effective for reviews of interim periods ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

AU 722.07

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 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.

AU 722.08 Heading

COMMENT ▼ TOOLS ▼

[The following heading was effective for interim periods within fiscal years beginning after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004.

Return to the current version.]

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AU 722.08

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for interim periods within fiscal years beginning after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004.

Return to the current version.]

.08

The accountant should establish an understanding with the client regarding the services to be performed in an engagement to review interim financial information. **fn 6** Such an understanding reduces the risk that either the accountant or the client may misinterpret the needs or expectations of the other party. This understanding should include the objectives of the engagement, management's responsibilities, the accountant's responsibilities, and the limitations of the engagement. The accountant should document this understanding, preferably through a written communication with the client. If the accountant believes an understanding with the client has not been established, he or she should decline to accept or perform the engagement.

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AU 722.09

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for interim periods within fiscal years beginning after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004.

Return to the current version.]

.09

An understanding with the client 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 principle

  [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.

  For reviews of interim periods ending before November 15, 2004, for accelerated filers, and July 15, 2005, for all other issuers, click here.]
- 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.

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AU 722.09

COMMENT ▼ TOOLS ▼

[The following bullet was effective for interim periods within fiscal years beginning after December 15, 2002. It was amended by PCAOB Auditing Standard No. 2, 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.

Return to the current version.]

AU 722.09

- A review is not designed to provide assurance on internal control or to identify reportable conditions. However, the accountant is responsible for communicating with the audit committee or others with equivalent authority or responsibility, regarding any reportable conditions that come to his or her attention

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AU 722.13

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for interim periods within fiscal years beginning after December 15, 2002. It was amended, effective for reviews of interim periods within fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.13

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 section 319, *Consideration of Internal Control in a Financial Statement Audit*. 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*.

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AU 722.16

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for interim periods within fiscal years beginning after December 15, 2002. It was amended, effective for reviews of interim periods within fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.16

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, *Analytical Procedures*, useful in conducting a review of interim financial information.

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AU 722.18

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for interim periods within fiscal years beginning after December 15, 2002. It was amended as a result of the adoption of Auditing Standard No. 5, effective for reviews of interim periods ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

AU 722.18

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 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. fn 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) 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. fn 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).

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 722.29

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for interim periods within fiscal years beginning after December 15, 2002. It was amended as a result of the adoption of Auditing Standard No. 5, effective for reviews of interim periods ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

AU 722.29

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 or (*b*) that 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.

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AU 722.30

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for interim periods within fiscal years beginning after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004.

Return to the current version.]

.30

If, in the accountant's judgment, management does not respond appropriately to the accountant's communication within a reasonable period of time, the accountant should inform the audit committee or others with equivalent authority and responsibility (hereafter referred to as the audit committee) of the matters as soon as practicable. This communication may be oral or written. If information is communicated orally, the accountant should document the communication.

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AU 722.32

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for interim periods within fiscal years beginning after December 15, 2002. It was amended as a result of the adoption of Auditing Standard No. 5, effective for reviews of interim periods ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

AU 722.32

When conducting a review of interim financial information, the accountant may become aware of fraud or possible illegal acts. If the matter involves fraud, it should be brought to the attention of the appropriate level of management. If the fraud involves senior management or results in a material misstatement of the financial statements, the accountant should communicate the matter directly to the audit committee as described in section 316, *Consideration of Fraud in a Financial Statement Audit, paragraphs .79 through .82. If the matter involves possible illegal acts, the accountant should assure himself or herself that the audit committee is adequately informed, unless the matter is clearly inconsequential.* **fn 21** *(See section 317, Illegal Acts by Clients, paragraph .17.)*

Footnotes (AU Section 722 — Interim Financial Information):

fn 21 The accountant may have additional communication responsibilities pursuant to section 317, *Illegal Acts by Clients*; Section 10A of the Securities Exchange Act of 1934; and section 316, *Consideration of Fraud in a Financial Statement Audit*.

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AU 722.33

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for reviews of interim periods ending on or after November 15, 2007. It was amended, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004.

Return to the current version.]

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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.

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AU 722.34

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for interim periods within fiscal years beginning after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004.

Return to the current version.]

.34

When conducting a review of interim financial information, the accountant also should determine whether any of the matters described in section 380, *Communication With Audit Committees*, as they relate to the interim financial information, have been identified. If such matters have been identified, the accountant should communicate them to the audit committee or be satisfied, through discussion with the audit committee, that such matters have been communicated to the audit committee by management. For example, the accountant should determine that the audit committee is informed about the process used by management to formulate particularly sensitive accounting estimates; about a change in a significant accounting policy affecting the interim financial information; about adjustments that, either individually or in the aggregate, could have a significant effect on the entity's financial reporting process; and about uncorrected misstatements aggregated by the accountant that were determined by management to be immaterial, both individually and in the aggregate, to the interim financial statements taken as a whole.

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AU 722.35

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for interim periods within fiscal years beginning after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004.

Return to the current version.]

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The objective of a review of interim financial information differs significantly from that of an audit. Therefore, any communication the accountant may make about the quality, not just the acceptability, of the entity's accounting principles 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 quality of the entity's accounting principles that would be identified as a result of an audit.

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AU 722.36

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for interim periods within fiscal years beginning after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004.

Return to the current version.]

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If the accountant has identified matters to be communicated to the audit committee, the accountant should attempt to make such communications with the audit committee, or at least its chair, and a representative of management before the entity files its interim financial information with a regulatory agency (such as the SEC). If such communications cannot be made before the filing, they should be made as soon as practicable in the circumstances. The communications may be oral or written. If information is communicated orally, the accountant should document the communications.

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AU 722.C5

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for interim periods within fiscal years beginning after December 15, 2002. It was amended, effective for reviews of interim periods within fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

C5. Certain terms are used in the illustrative letters that are described elsewhere in authoritative literature. Examples are *fraud*, in section 319, *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.

AU 722.08_fn6

COMMENT ▼ TOOLS ▼

[The following footnote was effective for interim periods within fiscal years beginning after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004.

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6 See Statement on Quality Control Standards (SQCS) No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, as amended, paragraph 16 [QC section 20.16].

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AU 722 Footnote 7

COMMENT ▼ TOOLS ▼

[The following footnote was effective for interim periods within fiscal years beginning after December 15, 2002. It was amended, effective for reviews of interm periods within fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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fn 7 Section 312, *Audit Risk and Materiality in Conducting an Audit*, paragraph .40, requires the auditor to document the nature and effect of misstatements that the auditor aggregates as well as the auditor's conclusion as to whether such misstatements, individually or in the aggregate, cause the audited financial statements to be materially misstated. Paragraphs .25 and .26 of this section describe the accountant's consideration of such misstatements in a review of interim financial information.

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AU 722 Footnote 20

COMMENT ▼ TOOLS ▼

[The following footnote was effective for interim periods within fiscal years beginning after December 15, 2002. It was deleted, effective for reviews of interim periods within fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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fn 20 Interpretation No. 4, "Considering the Qualitative Characteristics of Misstatements," of section 312, *Audit Risk and Materiality in Conducting an Audit*, provides additional guidance on evaluating whether misstatements are material.

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AU 722 Footnote 22

COMMENT ▼ TOOLS ▼

[The following footnote was effective for reviews of interim periods ending on or after November 15, 2004, for accelerated filers, and on or after July 15, 2005, for all other issuers. It was amended as a result of the adoption of Auditing Standard No. 5, effective for reviews of interim periods ending on or after November 15, 2007. See PCAOB Release 2007-005A.

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AU 722 FOOTNOTE 22

Footnotes (AU Section 722 — Interim Financial Information):

fn 22 Section 325, *Communications About Control Deficiencies in An Audit of Financial Statements*, provides guidance on communicating reportable conditions related to internal control.

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AU 722.34_fn23

COMMENT ▼ TOOLS ▼

[The following footnote was effective for interim periods within fiscal years beginning after December 15, 2002. It was amended, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release No. 2012-004.

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23 The presentation to the audit committee should be similar to the summary of uncorrected misstatements included in or attached to the management representation letter that is described in paragraph .24(*h*) of this section.

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AS 6115: Reporting on Whether a Previously Reported Material Weakness Continues to Exist

COMMENT ▼ TOOLS ▼

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 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 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 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 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 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.

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 (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.

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.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS4 Paragraph 1 - Note 1

COMMENT ▼ TOOLS ▼

[The following note became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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* .

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS No. 4 Paragraph 2

COMMENT ▼ TOOLS ▼

[The following paragraph became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005.

Return to the current version.]

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.)

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS No. 4 Paragraph 2 Note

COMMENT ▼ TOOLS ▼

[The following note became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS No. 4 Paragraph 4 Previous Version

COMMENT ▼ TOOLS ▼

[The following paragraph became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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.

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In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS No. 4 Paragraph 9

COMMENT ▼ TOOLS ▼

[The following paragraph became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS No. 4 Paragraph 10

COMMENT ▼ TOOLS ▼

[The following paragraph became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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.

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AS4_P10Note

COMMENT ▼ TOOLS ▼

[The following note became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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.*)

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS No. 4 Paragraph 11

COMMENT ▼ TOOLS ▼

[The following paragraph became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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/

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS No. 4 Paragraph 13

COMMENT ▼ TOOLS ▼

[The following paragraph became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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/

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS4_P17Note

COMMENT ▼ TOOLS ▼

[The following note became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

Auditing Standard No. 4 Paragraph 18

COMMENT ▼ TOOLS ▼

[The following paragraph was effective February 6, 2006. It was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

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).

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS No. 4 Paragraph 18 Note 2

COMMENT ▼ TOOLS ▼

[The following note became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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.

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AS No. 4 Paragraph 21

COMMENT ▼ TOOLS ▼

[The following paragraph became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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.

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS No. 4 Paragraph 23

COMMENT ▼ TOOLS ▼

[The following paragraph became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

23. The concept of materiality, as discussed in paragraphs 22 and 23 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. 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.

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS 4 Paragraph 24

COMMENT ▼ TOOLS ▼

[The following paragraph became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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.

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AS No. 4 Paragraph 25

COMMENT ▼ TOOLS ▼

[The following paragraph became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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.

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS No. 4 Paragraph 25 Note

COMMENT ▼ TOOLS ▼

[The following note became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS No. 4 Paragraph 26A

COMMENT ▼ TOOLS ▼

[The following subparagraph became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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.

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In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS No. 4 Paragraph 26b

COMMENT ▼ TOOLS ▼

[The following subparagraph became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS No. 4 Paragraph 26B Note

COMMENT ▼ TOOLS ▼

[The following note became effective February 6, 2006, and was deleted as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

b. 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.

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In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS No. 4 Paragraph 27

COMMENT ▼ TOOLS ▼

[The following paragraph became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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.

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AS No. 4 Paragraph 28 Note

COMMENT ▼ TOOLS ▼

[The following note became effective February 6, 2006, and was deleted as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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.

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AS No. 4 Paragraph 31

COMMENT ▼ TOOLS ▼

[The following paragraph became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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.

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AS No. 4 Paragraph 32

COMMENT ▼ TOOLS ▼

[The following paragraph became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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.

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AS No. 4 Paragraph 33

COMMENT ▼ TOOLS ▼

[The following paragraph became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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.

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AS No. 4 Paragraph 35

COMMENT ▼ TOOLS ▼

[The following paragraph became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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.

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AS No. 4 Paragraph 36

COMMENT ▼ TOOLS ▼

[The following paragraph became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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.

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AS No. 4 Paragraph 37

COMMENT ▼ TOOLS ▼

[The following paragraph became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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.

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AS No. 4 Paragraph 38

COMMENT ▼ TOOLS ▼

[The following paragraph became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AS No. 4 Paragraph 38 Note

COMMENT ▼ TOOLS ▼

[The following note became effective February 6, 2006, and was deleted as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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.

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AS No. 4 Paragraph 39 Note

COMMENT ▼ TOOLS ▼

[The following note became effective February 6, 2006, and was deleted as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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.

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AS No. 4 Paragraph 42

COMMENT ▼ TOOLS ▼

[The following paragraph became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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.

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AS No. 4 Paragraph 44F

COMMENT ▼ TOOLS ▼

[The following subparagraph became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS No. 4 Paragraph P51B Note

COMMENT ▼ TOOLS ▼

[The following note became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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.

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The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS No. 4 Paragraph 51L Note

COMMENT ▼ TOOLS ▼

[The following note became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AS No. 4 Paragraph 51O Note

COMMENT ▼ TOOLS ▼

[The following note became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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.

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AS No. 4 Paragraph 52

COMMENT ▼ TOOLS ▼

[The following paragraph became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

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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.

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AS No. 4 Paragraph 63

COMMENT ▼ TOOLS ▼

[The following paragraph became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to the current version.]

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.

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AS No. 4 Paragraph 64

COMMENT ▼ TOOLS ▼

[The following paragraph became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

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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.

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AS No. 4 Footnote 1

COMMENT ▼ TOOLS ▼

[The following footnote was effective for audits of fiscal years ending before November 15, 2007. It was deleted effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A

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1/ See paragraphs 68 to 70 of Auditing Standard No. 2 for additional information on relevant assertions.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AS No. 4 Footnote 2

COMMENT ▼ TOOLS ▼

[The following footnote became effective February 6, 2006, and was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

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2/ See paragraph 88 of Auditing Standard No. 2.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 9543.16

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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.16

Interpretation—The principal auditor's response should ordinarily be made by the auditor with final responsibility for the engagement. He should take those steps that he considers reasonable under the circumstances to be informed of known matters pertinent to the other auditor's inquiry. For example, the auditor with final responsibility may inquire of principal assistants **fn 4** responsible for various aspects of the engagement or he may direct assistants to bring to his attention any significant matters of which they become aware during the audit. The principal auditor is not required to perform any procedures directed toward identifying matters that would not affect his audit or his report.

[Issue Date: April, 1979.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 9543 Footnote 4

COMMENT ▼ TOOLS ▼

[The following footnote was deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

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fn 4 See section 311, *Planning and Supervision*, for the definition of "assistants."

[Issue Date: April, 1979.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 543.12

[The following paragraph was codified as part of Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures, in November 1972. It was amended 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 Auditing Standard No. 3. See PCAOB Release No.2004-006.

Return to the current version.]

AU 543.12

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 paragraph .10, he should also consider whether to perform one or more of the following procedures:

a. Visit the other auditor and discuss the audit procedures followed and results thereof.

b. 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 his audit work.

c. Review the working papers of the other auditor, including the understanding of internal control and the assessment of control risk.

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AU 9336.04

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.04

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 competent evidential matter."

[Issue Date: December, 2001.]

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AU 9336.05

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.05

Use of a legal specialist may not be necessary to obtain competent 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. **fn 4**

[Issue Date: December, 2001.]

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AU 9336.11

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.11

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 competent 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.

[Issue Date: December, 2001.]

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AU 9336.15

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.15

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..." fn 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. Section 326, *Evidential Matter*, paragraph .21, states that “to be competent, evidence, regardless of its form, must be both valid and relevant.” 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. **fn 12**

[Issue Date: December, 2001.]

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AU 9325

COMMENT ▼ TOOLS ▼

[The following note was 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. It was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

Return to current version.]

AU 9325

Note: In an audit of financial statements only, auditing interpretation 1 to AU sec. 325, "*Reporting on the Existence of a Material Weakness*" continues to apply except that the term "reportable condition" means "significant deficiency," as defined in paragraph 9 of PCAOB Auditing Standard No. 2.

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AU 9334 Footnote 4

COMMENT ▼ TOOLS ▼

[The following footnote was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

fn 4 Audit risk and its components are described in section 312, *Audit Risk and Materiality in Conducting an Audit*.

[Issue Date: May, 1986.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 9342.02

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.02

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 competent 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.

[Issue Date: February, 1993; Revised: October, 2000.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU Section 9342.07

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of fiscal years ending before June 1, 2014. See PCAOB Release No. 2013-008 for audits of fiscal years ending on or after June 1, 2014, or return to the current version.]

.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.

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AU Section 9342.08

COMMENT ▼ TOOLS ▼

[The following paragraph was effective for audits of fiscal years ending before June 1, 2014. See PCAOB Release No. 2013-008 for audits of fiscal years ending on or after June 1, 2014, or return to the current version.]

.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.

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU Section 9342.10

COMMENT ▼ TOOLS ▼

AUDITING GUIDANCE FOR FAIR VALUE INFORMATION

Required and Voluntary Information

[The following flowchart was effective for audits of fiscal years ending before June 1, 2014. See PCAOB Release No. 2013-008 for audits of fiscal years ending on or after June 1, 2014, or return to the current version.]

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AU 9337.04

COMMENT ▼ TOOLS ▼

[The following paragraph was issued in March 1977. It was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

[Return to the current version.]

AU 9337.04

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, which is generally the date of the completion of field work?

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AU 9337.05

COMMENT ▼ TOOLS ▼

[The following paragraph was issued in March 1977. It was amended as a result of the adoption of Auditing Standard No. 5, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A.

[Return to current version.]

AU 9337.05

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 report. Therefore, the latest date of the period covered by the lawyer's response (the "effective date") should be as close to the completion of field work as is practicable in the circumstances. Consequently, specifying the effective date of the lawyer's response to reasonably approximate the expected date of the completion of the field work will in most instances obviate the need for an updated response from the lawyer.

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AU 9550 Footnote 8

COMMENT ▼ TOOLS ▼

The following footnote was effective beginning January 2001. It was amended by PCAOB Auditing Standard No. 2, 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.

[Return to the current version.]

fn 8 Section 325.17 prohibits a written communication that no reportable conditions were noted during the audit. If management reports that an auditor made an oral communication that no reportable conditions were noted during the audit, the auditor should follow the guidance in this paragraph.

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AU 9508.02

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.02

Interpretation—Sufficient competent 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."

[Issue Date: July, 1975; Revised: October, 2000.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

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AU 9326.01-05

COMMENT ▼ TOOLS ▼

[The following paragraphs were deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

1. Evidential Matter for an Audit of Interim Financial Statements

.01

Question—APB Opinion No. 28 [AC section I73] concluded that certain accounting principles and practices followed for annual reporting purposes may require modification at interim report dates. Paragraph 10 of Opinion No. 28 [AC section I73.103] states that the modifications are needed "so that the reported results for the interim period may better relate to the results of operations for the annual period." The modifications introduce a need for estimates to a greater extent than is necessary for annual financial information. Does this imply a relaxation of the third standard of field work, which requires that sufficient competent evidential matter be obtained to afford a reasonable basis for an opinion regarding the financial statements under audit?

.02

Interpretation—No. The third standard of field work applies to all engagements leading to an expression of opinion on financial statements or financial information.

.03

The objective of the independent auditor's engagement is to obtain sufficient competent evidential matter to provide him with a reasonable basis for forming an opinion. The auditor develops specific audit objectives in light of assertions by management that are embodied in financial statement components. Section 326.11 states, "In selecting particular substantive tests to achieve the audit objectives he has developed, an auditor considers, among other things, the risk of material misstatement of the financial statements, including the assessed level of control risk, and the expected effectiveness and efficiency of such tests. His considerations include the nature and materiality of the items being tested, the kinds and competence of available evidential matter, and the nature of the audit objective to be achieved."

.04

Evidential matter obtained for an audit of annual financial statements may also be useful in an audit of interim financial statements, and evidential matter obtained for an audit of interim financial statements may also be useful in an audit of annual financial statements. Section 313.02 indicates that "Audit testing at interim dates may permit early consideration of significant matters affecting the year-end financial statements (for example, related party transactions, changed conditions, recent accounting pronouncements, and financial statement items likely to require adjustment)" and that "much of the audit planning, including obtaining an understanding of internal control and assessing control risk, and the application of substantive tests to transactions can be conducted prior to the balance-sheet date." fn 1 [As amended, August 1983, by issuance of Statement on Auditing Standards No. 45.] (See section 313.)

.05

The introduction by Opinion No. 28 [AC section I73] of a need for additional estimates in measuring certain items for interim financial information may lead to a need for evidence in examining those items that differs from the evidence required in an audit of annual financial information. For example, computing the provision for federal income taxes in interim information involves estimating the effective tax rate expected to be applicable for the full fiscal year, and the auditor should examine evidence as to the basis for estimating that rate. Since the effective tax rate for the full year ordinarily is known at year-end, similar evidence is not usually required in examining annual information.

[Issue Date: February, 1974; Modified: October, 1980.]

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AU 9326.10

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.10

The third standard of field work requires the auditor to obtain sufficient competent evidential matter through, among other things, inspection and inquiries to afford a reasonable basis for an opinion on the financial statements. Section 326, *Evidential Matter*, paragraph .25, requires the auditor to obtain sufficient competent 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.

[Issue Date: March, 1981; Amended: April 9, 2003.]

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AU 9326.12

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.12

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 competent 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. Section 326, *Evidential Matter*, paragraph .17, states that corroborating information includes information obtained by the auditor from inquiry, observation, inspection, and physical examination. The quantity, type, and content of audit documentation are matters of the auditor's professional judgment (see section 339.)

[Issue Date: March 1981; Amended: April 9, 2003.]

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AU 9326.13

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.13

The auditor's documentation of the results of auditing procedures directed at the tax accounts and related disclosures also should include sufficient competent 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.

[Issue Date: March 1981; Amended: April 9, 2003.]

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AU 9326.17

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.17

Interpretation—No. The opinion of legal counsel in this situation would not provide sufficient competent evidential matter to afford a reasonable basis for an opinion on the financial statements.

[Issue Date: March 1981; Amended: April 9, 2003]

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AU 9326.21

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.21

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 competent evidential matter to support his or her opinion.

[Issue Date: March 1981; Amended: April 9, 2003.]

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AU 9326.22

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.22

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 competent 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.

[Issue Date: March 1981; Amended: April 9, 2003.]

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AU 9326.23

COMMENT ▼ TOOLS ▼

[The following paragraph was amended, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

.23

If the auditor is unable to accumulate sufficient competent 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.]

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AU 9326.24-41

COMMENT ▼ TOOLS ▼

[The following paragraphs were deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

3. The Auditor's Consideration of the Completeness Assertion

.24

Question—Section 326, *Evidential Matter*, paragraph .03, identifies five categories of assertions that are embodied in financial statement components. In obtaining audit evidence about four of these categories—existence or occurrence, rights and obligations, valuation or allocation, and presentation and disclosure—the auditor considers transactions and accounts that are included in the financial statements. In contrast, in obtaining audit evidence about the completeness assertion, the auditor considers whether transactions and accounts have been improperly excluded from the financial statements. May management's written representations and the auditor's assessment of control risk constitute sufficient audit evidence about the completeness assertion? [Paragraph renumbered by the amendment to Interpretation No. 2, April 2003.]

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Interpretation—Written representations from management are a part of the evidential matter the auditor obtains in an audit performed in accordance with generally accepted auditing standards. Management's representations about the completeness assertion, whether considered alone or in combination with the auditor's assessment of control risk, do not constitute sufficient audit evidence to support that assertion. Obtaining such representations complements but does not replace other auditing procedures that the auditor should perform. [Paragraph renumbered by the amendment to Interpretation No. 2, April 2003.]

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In planning audit procedures to obtain evidence about the completeness assertion, the auditor should consider the inherent risk that transactions and accounts have been improperly omitted from the financial statements. When the auditor assesses the inherent risk of omission for a particular account balance or class of transactions to be such that he believes omissions could exist that might be material when aggregated with errors in other balances or classes, he should restrict the audit risk of omission by performing substantive tests designed to obtain evidence about the completeness assertion. Substantive tests designed primarily to obtain evidence about the completeness assertion include analytical procedures and tests of details of *related populations*. fn 2 [Paragraph renumbered by the amendment to Interpretation No. 2, April 2003.]

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The extent of substantive tests of completeness may properly vary in relation to the assessed level of control risk. Because of the unique nature of the completeness assertion, an assessed level of control risk below the maximum may be an effective means for the auditor to obtain evidence about that assertion. Although an assessed level of control risk below the maximum is not required to satisfy the auditor's objectives with respect to the completeness assertion, the auditor should consider that for some transactions (e.g., revenues that are received primarily in cash, such as those of a casino or of some charitable organizations) it may be difficult to limit audit risk for those assertions to an acceptable level without an assessed level of control risk below the maximum. [Paragraph renumbered by the amendment to Interpretation No. 2, April 2003.]

[Issue Date: April, 1986.]

4. Applying Auditing Procedures to Segment Disclosures in Financial Statements

.28

Introduction—Financial Accounting Standards Board (FASB) Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information* [AC section S30], establishes standards for the way that public business enterprises fn 3 disclose information about segments in annual financial statements and in condensed financial statements of interim periods issued to shareholders. FASB Statement No. 131 [AC section S30] does not apply to nonpublic entities or to not-for-profit organizations, although those entities are encouraged to provide the disclosures described therein. FASB Statement No. 131 [AC section S30] is effective for fiscal years beginning after December 15, 1997. [Paragraph renumbered by the amendment to Interpretation No. 2, April 2003.]

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FASB Statement No. 131 [AC section S30] requires that public business enterprises report financial and descriptive information about their reportable operating segments including factors used to identify reportable segments; a measure of profit or loss, certain revenue and expense items, and assets of reportable operating segments and the basis of measurement of these items; and reconciliations of these measures and any other significant operating segment items to enterprise totals. FASB Statement No. 131 [AC section S30] requires that the management approach be used to identify operating segments and to measure the financial information disclosed about operating segments. The management approach focuses on the financial information that an entity's chief operating decision maker (chief executive officer, chief operating officer or other individual or group exercising similar decision-making authority) uses internally to evaluate the performance of, and to allocate resources to, segments. FASB Statement No. 131 [AC section S30] also requires that public business enterprises report certain information about products and services, geographic areas, and major customers regardless of whether that information is used by management in assessing segment performance. [Paragraph renumbered by the amendment to Interpretation No. 2, April 2003.]

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Question—What is the auditor's objective when applying auditing procedures to segment disclosures in an entity's financial statements? [Paragraph renumbered by the amendment to Interpretation No. 2, April 2003.]

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Interpretation—The auditor performing an audit of financial statements in accordance with generally accepted auditing standards considers segment disclosures, as other informative disclosures, in relation to the financial statements taken as a whole. Accordingly, the auditor is not required to apply procedures as extensive as would be necessary to express an opinion on the segment information taken by itself. [Paragraph renumbered by the amendment to Interpretation No. 2, April 2003.]

.32

Question—What should the auditor consider with respect to segment disclosures in planning the audit? [Paragraph renumbered by the amendment to Interpretation No. 2, April 2003.]

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Interpretation—The auditor should obtain an understanding of who performs the function of the chief operating decision maker (CODM), and how management organizes the entity into operating segments for internal reporting purposes. The auditor also should consider the nature and extent of differences, if any, between the information systems used to generate data that the CODM uses to allocate resources to, and evaluate results of, the operating segments and the information systems that generate data for external reporting purposes. When a different system is used to generate the data underlying segment disclosures, the auditor needs to obtain only a general understanding of that system. Consistent with the management approach to accounting for segments, auditing procedures primarily are directed at obtaining sufficient competent evidential matter to support conclusions that the segment information disclosed is the same information that is used by the CODM; that the basis on which the information was prepared is the basis disclosed and the disclosures are adequate; that aggregation criteria have been appropriately applied, if applicable; and that all significant segment items are reconciled to consolidated totals in the financial statements. The types of procedures needed to obtain such evidence are described in paragraphs .35 and .37 of this Interpretation. [Paragraph renumbered by the amendment to Interpretation No. 2, April 2003.]

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Question—What procedures should the auditor consider performing to evaluate whether the entity appropriately identified its reportable operating segments in accordance with FASB Statement No. 131 [AC section S30]? [Paragraph renumbered by the amendment to Interpretation No. 2, April 2003.]

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Interpretation—Procedures that the auditor should consider performing to evaluate whether the entity appropriately identified its reportable operating segments in accordance with FASB Statement No. 131 [AC section S30] include the following:

a. Inquire of management concerning its methods of identifying operating segments, and consider the reasonableness of those methods in light of the characteristics of operating segments described in FASB Statement No. 131, paragraph 10 [AC section S30.109].

b. Review corroborating evidence, such as information that the CODM uses to assess performance and allocate resources, material presented to the board of directors, minutes from the meetings of the board of directors, and information that management provides in management's discussion and analysis (MD&A), to financial analysts, and in the chairman's letter to shareholders, for consistency with financial statement disclosures.

c. If the CODM uses more than one set of segment information for analyzing results of operations, consider whether management's identification of operating segments is in accordance with FASB Statement No. 131, paragraphs

13 through 15 [AC section S30.112-114].

d. Assess whether the entity has applied aggregation criteria, if applicable, and quantitative thresholds described in FASB Statement No. 131, paragraphs 17 through 24 [AC section S30.116-123], appropriately to determine its reportable operating segments.

e. Obtain management's written representation that operating segments are appropriately identified and disclosed in accordance with FASB Statement No. 131 [AC section S30].

[Paragraph renumbered by the amendment to Interpretation No. 2, April 2003.]

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Question—What procedures should the auditor consider performing to evaluate the adequacy and completeness of management's disclosures about reportable operating segments and about products and services, geographic areas, and major customers? [Paragraph renumbered by the amendment to Interpretation No. 2, April 2003.]

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Interpretation—The tests of underlying accounting records normally applied in an audit of financial statements may provide evidence about management's disclosures of information about products and services, geographic areas, and major customers, as well as how management allocates the entity's revenue, expenses, and assets among operating segments. The auditor should consider applying the following procedures to obtain additional evidence about segment disclosures:

a. Perform analytical procedures on the information about segments to identify and provide a basis for inquiry about relationships and individual items that appear to be unusual and may indicate misstatements. Analytical procedures, for purposes of this Interpretation, consist of comparison of the segment information with comparable information for the immediately preceding year and comparison of the segment information with any available related budgeted information for the current year. In applying these procedures, the auditor should consider the types of matters that in the preceding year have required accounting adjustments of segment information.

b. Evaluate the adequacy of disclosures with regard to (i) general information; (ii) information about reported segment profit or loss, segment assets, and the basis of measurement; and (iii) reconciliations of the totals of segment revenues, reported profit or loss, assets and other significant items to corresponding enterprise amounts, as required in FASB Statement No. 131, paragraphs 26 through 32 [AC section S30.125-131].

c. Review the reconciliations (including supporting schedules) of the totals of segment revenues, reported profit or loss, assets, and other significant items to consolidated totals to assess whether significant items are properly disclosed.

d. If the composition of an entity's reportable segments changes as a result of an entity's reorganization of its internal structure, assess whether segment information for prior periods has been restated, if practicable, in accordance with FASB Statement No. 131, paragraph 34 [AC section S30.133]. If restatement is not practicable, assess whether the segment information for the current period is stated under both the old basis and the new basis of segmentation in the year in which the change occurs, if practicable, in accordance with FASB Statement No. 131, paragraph 35 [AC section S30.134].

[Paragraph renumbered by the amendment to Interpretation No. 2, April 2003.]

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Question—What are the implications related to segment information for the auditor's report on the financial statements? [Paragraph renumbered by the amendment to Interpretation No. 2, April 2003.]

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Interpretation—The auditor's standard report on financial statements prepared in conformity with generally accepted accounting principles implicitly applies to segment information included in those statements in the same manner that it applies to other informative disclosures in the financial statements. The auditor's standard report would not refer to segment information unless the audit revealed a misstatement or omission relating to the segment information that is material in relation to the financial statements taken as a whole or the auditor was unable to apply the auditing procedures that he or she considered necessary in the circumstances. The auditor should consider qualitative as well as quantitative factors in evaluating whether such a matter is material to the financial statements taken as a whole. The significance of a matter to a particular entity (for example, a misstatement of the revenue and operating profit of a relatively small segment that is represented by management to be important to the future profitability of the entity), the pervasiveness of a matter (for example, whether it affects the amounts and presentation of numerous items in the segment information), and the impact of a matter (for example, whether it distorts the trends reflected in the segment information) should all be considered in judging whether a matter relating to segment information is material to the financial statements taken as a whole. Accordingly, situations may arise in practice where the auditor will conclude that a matter relating to segment information is qualitatively material even though, in his or her judgment, it is quantitatively immaterial to the financial statements taken as a whole. [Paragraph renumbered by the amendment to Interpretation No. 2, April 2003.]

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If the auditor concludes that an omission or misstatement of segment information is material to the financial statements taken as a whole, he or she should consider the reporting guidance in section 508, *Reports on Audited Financial Statements*, paragraphs .35 through .42, relating to departures from generally accepted accounting principles. If the auditor has been unable to perform auditing procedures on segment information that he or she considers necessary, the auditor should consider the reporting guidance in section 508.22 through .26 relating to scope limitations. [Paragraph renumbered by the amendment to Interpretation No. 2, April 2003.]

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Auditors are not required to refer in their audit reports (*a*) to changes required by the implementation of FASB Statement No. 131 [AC section S30] or (*b*) to subsequent changes in operating segments, provided that the financial statements clearly disclose that the information presented in segment disclosures for earlier periods has been restated, where applicable. Such disclosure would be similar to that for reclassification of prior-year financial information made for comparative purposes. In financial statements where segment information for earlier periods has not been restated, auditors are not required to refer in their audit reports to the variance in disclosure between the comparative periods, provided the financial statements clearly disclose why the earlier periods have not been restated. [Paragraph renumbered by the amendment to Interpretation No. 2, April 2003.]

[Issue Date: August, 1998; Revised: April, 2003.]

In conjunction with PCAOB Release No. 2014-001, the PCAOB is releasing a draft demonstration version of the proposed reorganized auditing standards to facilitate review of and comment on the proposed amendments to implement the reorganization. The demonstration version includes mapping tools and a revised guidance page that contains the auditing interpretations. Interested persons may comment as described in PCAOB Release No. 2014-001, or by using the comment button.

The proposed reorganization of the auditing standards in this demonstration version have not been adopted by the Board. The PCAOB auditing standards that are currently in effect can be found here.

AU 9326 Footnotes 1-3

COMMENT ▼ TOOLS ▼

[The following footnotes were deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release No. 2010-004.

Return to the current version.]

fn 1 See section 313, *Substantive Tests Prior to the Balance-Sheet Date* for guidance on the auditor's considerations before applying substantive tests to the details of asset or liability accounts at interim dates, including the relationship between the assessed level of control risk and such tests, and on extending the audit conclusions from such tests to the balance-sheet date. [Footnote added, August 1983, by issuance of Statement on Auditing Standards No. 45.]

fn 2 For purposes of this interpretation, a related population is a population other than the recorded account balance or class of transactions being audited that would be expected to contain evidence of whether all accounts or transactions that should be presented in that balance or class are so included. [Issue Date: April, 1986.]

fn 3 FASB Statement No. 131, paragraph 9 [AC section S30.108], states: "Public business enterprises are those business enterprises that have issued debt or equity securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets), that are required to file financial statements with the Securities and Exchange Commission, or that provide financial statements for the purpose of issuing any class of securities in a public market." [Issue Date: August, 1998; Revised: April, 2003]