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„Comparison of International Standards on Auditing with PCAOB Auditing Standards Regarding Material Misstatements and Implications for Statutory Auditors in the European Union“

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List of Abbreviations

ACFE	Association of Certified Fraud Examiners
AICPA	American Institute of Certified Public Accountants
AS(s)	Auditing Standard(s) (of PCAOB)
AU	Interim Auditing Standard (of PCAOB)
CPA(s)	Certified Public Accountant(s)
EC	European Commission
EU	European Union
IAASB	International Auditing and Assurance Standards Board
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
IPSAS(s)	International Public Sector Accounting Standard(s)
ISA(s)	International Standard(s) on Auditing
ISAE(s)	International Standard(s) on Assurance Engagements
ISQC(s)	International Standard(s) on Quality Control
ISRE(s)	International Standard(s) on Review Engagements
ISRS(s)	International Standard(s) on Related Services
IT	Information Technology
MARC	Maastricht Accounting, Auditing and Information Management Research Centre
PCAOB	Public Company Accounting Oversight Board
PwC	PricewaterhouseCoopers
SEC	Securities and Exchange Commission
U.S.	United States of America
USC	United States Code

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1 Introduction

1.1 Objective of the Thesis

Financial statement fraud is a serious and prevalent crime in today's business world. Various surveys conducted by auditing firms and other relevant institutions show its omnipresence; according to PricewaterhouseCoopers (PwC), accounting fraud has more than tripled between the years 2003 and 2009.[1] The Association of Certified Fraud Examiners (ACFE) identifies financial statement fraud as the most costly category of fraud with a median loss of USD 4.1 million for a single case.[2] Hence, the regulation of auditing, particularly regarding material misstatements due to error or fraud, has become increasingly important. Internationally recognised auditing standards are exempli gratia the International Standards on Auditing (ISAs). Likewise, ISAs show growing popularity being implemented by jurisdictions like Australia, Brazil and Canada.[3] In most European Union (EU) member states ISAs are already in use and it is anticipated that the European Commission (EC) will adopt ISAs too.[4] However, the United States of America (U.S.) have their own auditing standards established by the Public Company Accounting Oversight Board (PCAOB) for in the U.S. listed companies. Since many EU companies are listed at U.S. stock exchanges, exempli gratia more than 90 from 13 EU member states at the New York Stock Exchange, there is a growing necessity for the compliance of PCAOB standards in addition to ISAs.[5]

This thesis presents two comparative analyses of International Standards on Auditing (ISAs) and Auditing and Interim Standards by the PCAOB regarding material misstatements published by the PCAOB[6] and the EC[7]. The two comparisons were published in 2009 and 2010 respectively and thus cover different versions of standards. On the basis of these two comparisons, the standards where differences had been detected shall be compared again in the current versions of both standard sets. The new comparison shall show that the Clarity Project by the International Auditing and Assurance Standards Board (IAASB)[8] as well as Docket 026[9] – under which new and

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[1] Confer *PricewaterhouseCoopers* (2009), page 7.
[2] Confer *Association of Certified Fraud Examiners* (2010), page 11
[3] Confer *International Federation of Accountants* (2011), Support and Guidance.
[4] Confer Chapter 1.4.1 EU Directive on Statutory Audit.
[5] Confer *New York Stock Exchange* (2011) and 1.4.2 U.S. Foreign Corrupt Practices Act.
[6] PCAOB Rulemaking Docket Matter No. 026. Confer Chapter 2.1 PCAOB Comparison of ISAs with PCAOB Auditing Standards.
[7] EU Project N° MARKT/2007/15/F LOT 2. Confer Chapter 2.2 EC-MARC Comparison of ISAs with PCAOB Auditing Standards.
[8] The IAASB is the standard setting board for ISAs.
[9] Confer Chapter 1.3.2.2. Auditing and Interim Standards.

existing standards have been established and amended respectively – by the PCAOB have reduced the differences between the two standard sets. Since both institutions published comprehensive comparative analyses about the differences between the two standard sets, and the amendments of these standards do not appear to diverge from each other but rather to converge to each other, no replication of the comparative analysis shall be conducted. Furthermore, the implications of the remaining differences for EU statutory auditors who have to apply both standard sets shall be discussed.

Multi-location engagements[10] are not covered in this thesis. Although the PCAOB comparative analysis included standards regarding multi-location engagements, these are omitted in the review of the comparison (2.1.) due to better comparability; as, the EC-MARC study did not cover multi-locations engagements either.

An analysis of wording differences such as “shall” versus “should” is not part of this thesis because this kind of difference is a matter of interpretation by each jurisdiction. Furthermore, the experts of the EC-MARC study perceived that the terminology used in standards has a “moderate impact” on the audit performance.[11] For these reasons, differences in terminology as introduced in chapters 3 and 4 are presented in these chapters – however, not further discussed.

1.2 Structure of the Thesis

The thesis is structured as follows. In subchapter 1.3 the two standards sets, ISAs and the PCAOB standard set, as well as their establishing institutions, the International Federation of Accountants (IFAC) and the Public Company Accounting Oversight Board (PCAOB), are presented; and subchapter 1.4 discusses the legal implications for statutory audits in the European Union (EU), id est which standards need to be complied with when auditing a EU company controlled by a U.S. company or with a (cross-) listing in the U.S. Hence, this subchapter explains why the PCAOB standard set is relevant for EU statutory auditors.

Chapter 2 comprises reviews of two previous comparisons between ISAs and PCAOB standards, published by the PCAOB and the European Commission (EC); the latter was performed by the Maastricht Accounting, Auditing and Information Management Research Centre (MARC). Subchapters 2.1 and 2.2 are structured in the same way, including an outline of the comparisons, as well as the same division of topics as the

[10] According to AS 9.11, a multi-location engagement is “an audit of the financial statements of a company with operations in multiple locations or business units“.

[11] Confer *Maastricht Accounting, Auditing and Information Management Research Center* (2009), page 10.

two main chapters 3 and 4. These are Risks of Material Misstatements (3.1), Consideration of Material Misstatements (3.2), Auditor's Responsibilities Regarding Fraud (4.1), and Consideration of Fraud in a Statutory Audit (4.2). These four topics are similar to the topic classification of the EU-MARC study, but amended for the purpose of this thesis.[12] Only subchapter 2.2 contains a section presenting the impact of differences on audit practice, since the EC-MARC study also includes such a presentation. In subchapter 2.3, the differences of results between the two comparisons are discussed.

Chapter 3 and 4 constitute the core part of this thesis, comprising a new comparison of the differences presented in chapter 2. Furthermore, both chapters contain the same 3 sections which are a comparison of the standard sets, a presentation of the assessed differences as well as a discussion about the implications of the differences for statutory auditors in the EU when auditing an EU company controlled by a U.S. company or (cross-) listed in the U.S. All sections covering differences include a synopsis of the differences in a table presenting the relevant topic and a brief description of the subject where the differences exist.

Finally, chapter 5 concludes on the findings presented in the chapters above. In addition, the last chapter summarises the results, contains a critical perspective on the present analysis including methodological strengths and weaknesses, and concludes with a desirable prospective harmonisation of auditing standards.

1.3 Auditing Standards and Their Establishing Institutions

1.3.1 The International Federation of Accountants and its Auditing Standards

1.3.1.1 The IFAC and the IAASB

In October 1977, the International Federation of Accountants (IFAC) was founded at the eleventh World Congress of Accountants in Munich, Germany. The headquarters of the IFAC is located in New York City, NY. At the IFAC's formation, the organisation counted 63 members; in 2011, the membership has grown to 164 members and associates in 125 jurisdictions and countries, including all EU member states and the U.S.[13]

Some of the main activities of the IFAC are to increase the role of regulation of the international profession, to enhance the communication with stakeholders, to develop

[12] For more detailed information on the topology of the study see section 2.2.1.
[13] Confer *International Federation of Accountants* (2011), History.

International Public Sector Accounting Standards (IPSASs) and to build a closer liaison with accountancy firms. Moreover, IFAC's activities also include the expansion of the focus on SMEs and developing nations, an increase in collaboration with IFAC members, and an improvement of the outreach to regional accountancy organisations.[14]

One of the nine boards and committees established by the IFAC includes the International Auditing and Assurance Standards Board (IAASB). The IAASB was also founded in October, 1977 and formerly known as the "International Auditing Practices Committee"[15]. This board was established to develop, monitor and facilitate the adoption of, and to respond to concerns about implementing international standards.[16]

The following standards were established by the IAASB[17]:

- *International Standards on Auditing (ISAs)*
  ISAs are standards for auditing historical financial information. See 1.3.1.2 for detailed information.
- *International Standards on Review Engagements (ISREs)*
  ISREs are standards for reviewing historical financial information.
- *International Standards on Assurance Engagements (ISAEs)*
  ISAEs are standards for performing assurance engagements not dealing with historical financial information.
- *International Standards on Related Services (ISRSs)*
  ISRSs are standards for performing related services engagement as specified by the IAASB.
- *International Standards on Quality Control (ISQCs)*
  ISQCs are standards for performing services under ISAs, ISAEs and ISRSs.

1.3.1.2 International Standards on Auditing

The International Standards on Auditing (ISAs) are standards for auditors to be adhered to when performing an audit – in which specific jurisdictions ISAs are applied, see in subsection (1.4.1). The "2010 Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements", published by the IAASB, comprises all 36 Clarified ISAs and ISQC1 – the current version of the standards.

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[14] Ibidem.
[15] Confer *International Federation of Accountants* (2011), About IAASB.
[16] Ibidem.
[17] Confer *International Federation of Accountants* (2011), Terms of Reference.

During the course of implementation of the IAASB's Clarity Project, 20 ISAs were redrafted, 16 revised and one newly developed.[18] The objective of this project was to review ISAs in order to improve their clarity and to ensure their consistent application. At the end of 2008, the project was completed and the Clarified ISAs became effective for periods beginning on or after December 15, 2009.[19]

The structure of the Clarified ISAs is as follows[20]:

- *Introduction*

  The introduction comprises the purpose, scope, and subject matter of the ISA, as well as the responsibilities of the auditor and others in respect to the individual standard.
- *Objective*

  The objective comprises a clear statement of the auditor's objective in respect to the individual standard.
- *Definitions*

  The definitions sector comprises definitions of applicable terms for better understanding of the ISAs.
- *Requirements*

  The requirements are expressed by the phrase "the auditor shall" and support the objective of the individual standard.
- *Application and other explanatory material*

  The application and other explanatory material comprises explanations about the meaning and intention of the requirements, as well as examples of procedures.

While ISAs' requirements clearly have to be followed, it is not explicitly stated that the application and other explanatory material is binding. ISA 200.19[21] requires the auditor to "have an understanding of the entire text of an ISA, including its application and other explanatory material, to understand its objectives and to apply its requirements properly." Furthermore, ISA 200.A59 states that "[w]here necessary, the application and other explanatory material provides further explanation of the requirements of an ISA and guidance for carrying them out. […] While such guidance does not in itself

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[18] Confer *International Federation of Accountants* (2011), The Clarified Standards.
[19] Confer *International Federation of Accountants* (2011), Clarity of IAASB Standards – Completed.
[20] Confer *International Federation of Accountants* (2011), The Clarified Standards.
[21] "ISA 200: Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing" sets out the "overall objectives of the auditor", and "explains the nature and scope of an audit", as well as "the scope, authority and structure of the ISAs" (ISA 200.1).

impose a requirement, it is relevant to the proper application of the requirements of an ISA." Hence, the application and other explanatory material of ISAs does not have to be applied mandatorily.

1.3.2 The Public Company Accounting Oversight Board and its Auditing Standards

1.3.2.1 The PCAOB

The United States Congress established the Public Company Accounting Oversight Board (PCAOB) through the Sarbanes Oxley Act of 2002. The PCAOB is a non-profit corporation with headquarters in Washington, DC. The Security Exchange Commission (SEC) has oversight authority over the PCAOB and appoints the five members of its board.[22]

One of the duties of the PCAOB under 15 USC 7211 (c) (2) is to "establish or adopt, or both, by rule, auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers, brokers, and dealers, in accordance with section 7213 of this title". Before new standards are effective, the SEC has to approve them.[23]

The following standards were established, or adopted as interim standards from the American Institute of Certified Public Accountants (AICPA), by the PCAOB:[24]

- *Auditing standards*
  Auditing standards are standards for independent auditors and offer audit quality measures and audit objectives.[25]
- *Ethics and independence standards*
  Ethics and independence standards are standards for members in public practice performing "any professional service"[26].
- *Quality control standards*
  Quality control standards are standards for a Certified Public Accountants (CPA) firm's system of quality control regarding its accounting and auditing practice.[27]
- *Attestation standards*
  Attestation standards are standards for practitioners (CPAs in practice of public accounting) when issuing an examination, a review, or an agreed-upon procedures

[22] Confer *Public Company Accounting Oversight Board* (2011), About the PCAOB.
[23] Confer *Public Company Accounting Oversight Board* (2011), Auditing Standards.
[24] Confer *Public Company Accounting Oversight Board* (2011), Standards.
[25] Confer AU 150.
[26] Confer ET Section 101 and ET Section 102.
[27] Confer QC Section 20.

report or an assertion regarding "subject matters" (historical or prospective performance or condition, physical characteristics, historical events, analyses, systems and processes, as well as behaviour).[28]

1.3.2.2 Auditing and Interim Standards

As a standard-setting corporation, the PCAOB adopted pre-existing standards as its interim standards on a transitional basis in April 2003. These interim standards were established by the American Institute of Certified Public Accountants (AICPA) and are labelled with the abbreviation "AU".[29] The PCAOB adopted the AICPA's standards as its interim standards "in order to assure continuity and certainty in the standards that govern audits of public companies"[30]. AUs are classified as follows:[31]

- *AU Section 100*
  This section comprises the introductory part with statements on auditing standards.
- *AU Section 200*
  This section comprises the general standards of the standard set.
- *AU Section 300*
  This section comprises the standards of field work.
- *AU Section 400*
  This section comprises the first three standards of reporting.
- *AU Section 500*
  This section comprises the fourth standard of reporting.
- *AU Section 600*
  This section comprises standards regarding other types of reports.
- *AU Section 700*
  This section comprises standards dealing with special topics in auditing.
- *AU Section 800*
  This section comprises standards on compliance auditing.
- *AU Section 900*
  This section comprises standards dealing with special reports on auditing procedures.

Since the adoption of the interim standards, the PCAOB has adopted 15 new standards in addition to or superseding certain interim standards. These new standards

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[28] Confer AT Section 101.
[29] Confer *Public Company Accounting Oversight Board* (2011), Auditing Standards.
[30] Confer *Public Company Accounting Oversight Board* (2003), PCAOB Release No. 2003-006: Establishment of Interim Professional Auditing Standards.
[31] Confer *Public Company Accounting Oversight Board* (2011), Auditing Standards.

are labelled with the abbreviation “AS” and numbered from 1 to 15.[32] AS 1 sets the regulatory frame for auditing standards and AS 1.1 states that “PCAOB Rule 3100, *Compliance with Auditing and Related Professional Practice Standards*, requires the auditor to comply with all applicable auditing and related professional practice standards of the PCAOB”. The ASs do not have any specific structure like ISAs.

Most of the interim standards related to the assessment of and responses to risks were created in the 1980s.[33] Hence, the PCAOB proposed the implementation of AS 8-15, as well as the amendment of 26 interim auditing standards (AU), 5 ASs and one ethics standard in October 2008 through Docket 026.[34] “Docket 026 : Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards” had the overall aim of updating the requirements of the standards and interim standards related to the assessment of and responses to risks.[35] The concrete objectives of Docket 026 were the improvement of auditing standards, the enhancement of effectiveness of risk assessment and responses to risks, the emphasis of auditors’ responsibilities regarding fraud consideration, and the enhancement of “integrated audits”[36].[37] All standards amended or established through Docket 026, became effective for fiscal years beginning on or after December 15, 2010.[38] See subchapter 2.1.1 for a description of AS 8-15.

1.4 Legal Implications for Statutory Audits in the EU

1.4.1 EU Directive on Statutory Audit

On May 17, 2006 the European Parliament and the Council passed the Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts. This directive includes the adoption of international auditing standards by the European Commission. The Federation of European Accountants stated in its Policy Statement in April 2009 that even though the Directive 2006/43/EC does not specify which international auditing standards the EC has to adopt, “it is anticipated that these will be

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[32] Ibidem.
[33] Confer *Public Company Accounting Oversight Board* (2010), SEC Filing – PCAOB Rulemaking Docket Matter No. 026, p. 4.
[34] Confer *Public Company Accounting Oversight Board* (2010), SEC Filing – PCAOB Rulemaking Docket Matter No. 026, p. 5, 110-145.
[35] Confer *Public Company Accounting Oversight Board* (2010), SEC Filing – PCAOB Rulemaking Docket Matter No. 026, p. 5.
[36] An integrated audit is an audit of financial statements with an audit of internal control.
[37] Confer *Public Company Accounting Oversight Board* (2010), SEC Filing – PCAOB Rulemaking Docket Matter No. 026, p. 5-6.
[38] Confer *Public Company Accounting Oversight Board* (2010), SEC Filing – PCAOB Rulemaking Docket Matter No. 026, p. 507.

ISAs as they are the only internationally accepted high quality auditing standards"[39]. Although the EC has not yet adopted an international auditing standard set, most EU member states have either required ISAs by national law or regulation[40] (exempli gratia Bulgaria, Slovakia and Slovenia), adopted[41] ISAs (exempli gratia the Czech Republic, Ireland and the United Kingdom), or incorporated[42] ISAs into national standards (exempli gratia Denmark, Finland and Sweden).[43] According to the IFAC, 20 of 27 EU member states use, or indicate that they will use the Clarified ISAs from the year 2011 onwards. The seven countries not using the Clarified ISAs according to IFAC are Austria, France, Germany, Italy, Poland, Portugal and Spain.[44] Furthermore, IFAC states that France, Germany, Italy, Poland and Portugal have already incorporated ISAs into national standards.[45] Moreover, the EC has published two independent studies, one evaluating the differences between ISAs and PCAOB standards, and the second analysing the costs and benefits of ISAs being adopted in the EU.[46] This might be considered as a clear indicator that the EC will adopt ISAs. The "Consultation on the Adoption of International Standards on Auditing"[47] by the EC from March 2010 has shown that there is no common consent among commenters regarding the timing of adoption. Currently, there is no date or time period specified when the EC is going to adopt ISAs for mandatory application in the EU.

Hence, 25 of 27 jurisdictions in the EU have implemented or modified their own national standards based on ISAs for statutory audits. Therefore, all statutory audits of companies within these EU member states have to or will have to be performed in compliance with the Clarified ISAs, allowing for exceptions resulting from different legal or regulatory requirements depending on each country's jurisdiction. As soon as the EC adopts ISAs, they will have to be applied in all EU jurisdictions for statutory audits.

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[39] Confer *Fédération des Experts compables Eurpéens* (2009), page 3.

[40] "Required ISAs by national law or regulation" signifies that the country law or regulation requires the use of ISAs as issued by the IAASB. Confer *International Federation of Accountants* (2011), Basis of ISA Adoption.

[41] "Adopted ISAs" signifies that the national standard-setter has adopted ISAs for use in the country and that there are no separate local standards. Confer *International Federation of Accountants* (2011), Basis of ISA Adoption.

[42] "Incorporated ISAs into national standards" signifies that ISAs have been adopted as the local standard set with possible national modifications. Confer *International Federation of Accountants* (2011), Basis of ISA Adoption.

[43] Confer *International Federation of Accountants* (2011), Basis of ISA Adoption.

[44] Confer *International Federation of Accountants* (2011), Support and Guidance.

[45] Confer *International Federation of Accountants* (2011), Basis of ISA Adoption.

[46] Confer *European Commission* (2011), International Standards on Auditing (ISAs).

[47] Confer *European Commission* (2010), Summary of Comments – Consultation on the Adoption of International Standards on Auditing.

1.4.2 U.S. Foreign Corrupt Practices Act

The Foreign Corrupt Practices Act was passed in the U.S. in 1977. The thereby established 15 USC Chapter 27.II.A.1 “requires issuers (and issuers only) to maintain specific recordkeeping standards and adequate internal accounting controls”. Furthermore, Chapter 27.II.B states that the accounting provisions apply to all stock issuers in the U.S. as well as subsidiaries and joint ventures controlled by U.S. issuers holding more than 50 percent of the stock. Hence, also foreign companies which are either stock issuers in the U.S. or controlled by a U.S. company holding more than 50 percent must adhere to U.S. law and regulation regarding recordkeeping standards and internal accounting controls.

In the year 2002, the Sarbanes Oxley Act was passed by the Congress of the United States of America, which empowered the Securities and Exchange Commission (SEC) to dictate rules and regulations regarding financial management and reporting of publicly held U.S. companies. This act implicated that auditing standards established by the Public Company Accounting Oversight Board (PCAOB) have to be applied during statutory audits of all U.S. public companies.[48]

Hence, PCAOB auditing standards have to be adhered to by publicly held U.S. companies. Due to the Foreign Corrupt Practices Act, foreign companies which are either stock issuers in the U.S. or controlled by a U.S. company holding more than 50 percent also must have their statutory audits performed in compliance with PCAOB auditing standards.

[48] Confer *Public Company Accounting Oversight Board* (2011), About the PCAOB.

2 Review of Previous Comparisons of ISAs with PCAOB Auditing Standards

2.1 PCAOB Comparison of ISAs with PCAOB Auditing Standards

2.1.1 Outline of the Comparison

On October 21, 2008 the first draft for amending interim auditing standards and adopting new rules related to assessing and responding to risk (Docket 026[49]) was released by the PCAOB. In course of this project, three papers had been published containing the proposed rules, discussions and each with a comparison of the new standards and ISAs, and the auditing standards of the American Institute of Certified Public Accountants (AICPA). It has to be noted that this comparison did not cover the application and other explanatory material of ISAs.

In general, the differences between the PCAOB standard set and ISAs were presented by citing the analogue standards, inter alia the relevant paragraphs and briefly outlining the differences. Although the structure itself was clear and logical, the individual cited paragraphs or ISAs were not named, which made the comparison less transparent. Furthermore, the comparisons by the PCAOB were non-judgmental and therefore, the below review is non-judgmental too. No expert opinions were included.

The final rules were released on August 5, 2010 and presented in Appendix 11 the comparative analysis which was divided into eight parts id est the eight new standards:

- *AS 8 Audit Risk*

  The standard's objective is the reduction of audit risk. The PCAOB's comparison for this standard can be found on pages 242-244.
- *AS 9 Audit Planning*

  The standard's objective is an effectively planned audit. The PCAOB's comparison for this standard can be found on pages 244-248.
- *AS 10 Supervision of the Audit Engagement*

  The standard's objective is a supervision that ensures the audit to be performed as directed, and to support reached conclusions. The PCAOB's comparison for this standard can be found on pages 248-250.

[49] Docket 026: Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards.

- *AS 11 Consideration of Materiality in Planning and Performing an Audit*
  The standard's objective is an appropriate application of the materiality concept. The PCAOB's comparison for this standard can be found on pages 250-255.
- *AS 12 Identifying and Assessing Risks of Material Misstatements*
  The standard's objective is the creation of a basis for responding to risks of material misstatements. The PCAOB's comparison for this standard can be found on pages 255-271.
- *AS 13 The Auditor's Responses to the Risks of Material Misstatements*
  The standard's objective is the appropriate treatment of risks of material misstatements. The PCAOB's comparison for this standard can be found on pages 271-280.
- *AS 14 Evaluating Audit Results*
  The standard's objective is the determination whether obtained audit evidence is sufficient and appropriate. The PCAOB's comparison for this standard can be found on pages 280-288.
- *AS 15 Audit Evidence*
  The standard's objective is the obtainment of sufficient and appropriate audit evidence. The PCAOB's comparison for this standard can be found on pages 288-291.

The following four subsections deal with the differences discussed in Appendix 11. These subsections arose from the four subchapters of Chapter 3 and 4, the core part of the thesis. The new standards are discusses in regard to content, and thus, structured accordingly. While the PCAOB comparative analysis is non-judgmental, the EC-MARC study is rating the differences. A comparison between the two comparative analyses by the author of this thesis is in subchapter 2.3. The subsections 2.1.2-2.1.5 only comprise the content of the PCAOB comparison annexed in Docket 026 and no other opinion. However, subchapter 2.3 presents the opinion of the author of this thesis.

2.1.2 Risks of Material Misstatements

The following standards were compared:

- ISA 200, ISA 240, ISA 315, ISA 330, ISA 450, ISA 520, ISA 540, ISA 700
- AS 8, AS 12, AS 13, AS 14

The following requirements regarding the obtainment of *understanding the company* are in contrast to ISAs only included in AS 12. First, the auditor has to evaluate whether significant changes from prior periods affect risks of material misstatement. Second, sources of obtaining an understanding also comprise public information, transcripts of earnings calls, trading activity of the company's securities and holdings

by significant holders. Third, possible IT effects on the company's flow of transactions need to be considered. Moreover, both standard sets require the obtainment of understanding the management's risk assessment process. However, ISA 315 provides – in the contrary to PCAOB standards – additional guidance in case the auditor identifies risks of material misstatement that have not been discovered before by the management, or the company has not established such an assessment process.

It is stated in ISA 315.12 that the auditor has to "obtain an *understanding of internal control* relevant to the audit"[50] and that relevant internal controls relating to financial reporting are subject to professional judgement of the auditor. AS 12.18, in contrast, instructs the auditor to "obtain a sufficient understanding of each component of internal control over financial reporting". Hence, the focus of AS 12 is on the sufficiency of understanding, whereas it is on internal control in ISA 315. A similar difference exists regarding control activities between AS 12 and ISA 315. Furthermore, AS 12.24 lists inter alia that the auditor shall evaluate "whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control". Although ISAs do not contain this requirement, ISA 315.14 (b) instructs the auditor to assess whether the "strengths in the control environment elements collectively provide an appropriate foundation for other components of internal control". In contrast to ISAs, AS 12 requires the auditor, when assessing control risk or performing an audit of internal control, to consider gathered evidence while obtaining the understanding of internal control.

AS 12 and ISA 315 both require the auditor to *identify and assess risks of material misstatements*. However, AS 12.3 preceded the verb "assess" with "appropriately". Moreover, AS 12 contains the requirement to carry out other risk assessment procedures beyond understanding the company and its environment. ISAs do not require these additional risk assessment procedures, but the understanding of an entity's internal control. Unlike ISAs, AS 12.44 instructs the auditor to assess whether a review of interim financial information contains relevant information for identifying risks of material misstatements for the year-end audit. According to ISA 315, engagement partners shall consider whether information gathered during performing other engagements for the entity is relevant to identify risks of material misstatements. AS 12 contains the same requirement; however, it is not limited to information obtained during other services carried out by the engagement partner, but expands this requirement to all services performed by the firm and its affiliates.

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[50] All italics highlighting of terms of phrases within direct citations have been undertaken by the author of this thesis for better comprehension.

Unlike ISAs, AS 12 comprises additional requirements regarding the identification and assessment of risks of material misstatements. AS 12.59 (c) requires the evaluation of how risks at the assertion level could be affected by risks at the financial statement level. AS 12.60-62 demand the identification of significant accounts and disclosures as well as of their relevant assertions. Furthermore, substantive procedures and tests of controls have to be performed for relevant assertions of significant accounts and disclosures.

The definition of *significant risks* differs between the two standard sets. ISA 315.4 (e) defines a significant risk as an "identified and assessed risk of material misstatement that, in the auditor's judgement, requires special audit consideration". The definition of the term "significant risk" stated in AS 12.A5 excludes the terms of "identified and assessed", as well as "in the auditor's judgement".

AS 12 and ISA 315 require that *risk assessment procedures* are performed as a basis for the identification and assessment of risks of material misstatements. AS 12.4 refines this requirement by demanding procedures that are "sufficient to provide a reasonable basis" and adds, besides identification and assessment, the designing of further audit procedures. Hence, the PCAOB standard stipulates a determination of sufficiency for necessary risk assessment procedures. Compared to ISA 315, AS 12 and in particular AS 12.5 provide more guidance for performing analytical procedures to assess risks of material misstatements. Unlike ISAs, AS 12.55 demands from the auditor the usage of "his or her knowledge of the company and its environment" and information gathered from other risks assessment procedures for determining "the nature of inquiries about risks of material misstatements". Both standard sets demand analytical procedures connected to revenue. However, unlike ISAs, AS 14.7 explicitly requires the performance of these analytical procedures "through the end of the period".

Unlike ISAs, AS 8.11 instructs the auditor to increase evidence obtained from *substantive procedures* as "the appropriate level of detection risk decreases". AS 13 requires the performance of substantive procedures only for accounts and disclosures associated with identified risks of material misstatements; in comparison to AS 13, ISA 330 instructs the auditor to perform substantive procedures for all material accounts and disclosures, regardless of assessed risks. Furthermore, ISA 330 explicitly requires the "consideration" of performing external confirmation procedures as substantive audit procedures. AS 13.36 instructs the "performance" of substantive procedures "for each relevant assertion of each significant account and disclosure". In

addition, “AU 330: The Confirmation Process” provides the auditor with detailed guidance about confirmation procedures.

While AS 8.3 requires the auditor to obtain “reasonable assurance” by reducing audit risk to “an appropriately low level”, ISA 200.17 demands the auditor to “obtain sufficient appropriate *audit evidence* to reduce audit risk to an acceptably low level”. The wording seems to be more precise by the PCAOB standard, compared to ISA 200 which leaves auditors the possibility to adjust audit efforts to personal risk tolerance.

2.1.3 Consideration of Material Misstatements in a Statutory Audit

The following standards were compared:

- ISA 200, ISA 220, ISA 240, ISA 300, ISA 320, ISA 330, ISA 450, ISA 500, ISA 520, ISA 540, ISA 600, ISA 700
- AS 9, AS 10, AS 11, AS 13, AS 14, AS 15, AU 330

Both standard sets instruct the auditor to determine *materiality* level for the financial statements as a whole when establishing an audit strategy. Additionally, AS 11.6 specified the materiality level to be “appropriate in light of the particular circumstances”. For purposes of assessing risks of material misstatements, AS 11.8 asks the auditor to determine “tolerable misstatement”, whereas ISA 320.11 demands the determination of “performance materiality”. As opposed to ISAs, AS 11 requires the consideration of misstatements from prior audits for both, the determination of tolerable misstatement and the performance of the audit. AS 11 and ISA 320 deal with possible necessary revisions of established materiality level (and tolerance misstatements). Though, AS 11.11 reflects the perspective of a “reasonable investor”, while ISA 320.12 reflects that of the “auditor”.

Unlike ISAs, AS 9.4 explicitly demands the auditor to “properly plan” the audit, and AS 9.10, to “document” the *audit plan*. Although both standard sets require the development of an audit plan including a description of the nature, timing, and extent of audit procedures, only ISA 300 limits audit procedures to the assertion level.

In contrast to ISAs, AS 10.4 provides the option to “seek assistance from appropriate engagement team members” for the *supervision* of the audit engagement to the engagement partner. Furthermore, AS 10 includes, unlike ISAs, a description of supervision elements, factors which may affect supervision and a list of aspects to be considered when determining the extent of necessary supervision. AS 10 offers more guidance regarding engagement team supervision activities than ISA 220.

While AS 13.2 defines the objective of *audit responses* and procedures as "address[ing] the risks of material misstatement", ISA 330 states that the objective is to obtain audit evidence for these risks. ISA 330 limits overall responses to risks of material misstatements to the financial statement level and assessed risks, including fraud. In contrast to ISAs, AS 13 does not limit the overall responses to the financial statement level, and provides more guidance how to design and implement those. Furthermore, the PCAOB standard includes a requirement for determining the need for significant changes of audit procedures in order to appropriately address the assessed risk of material misstatements.

AS 13 covers three requirements regarding *tests of controls*, which are not included in ISAs. First, tests of controls in an integrated audit have to conform to the objectives of audits of financial statements and internal control. Second, when testing the operating effectiveness of a control, it is necessary to assess the necessary authority and competence of the person performing the control. Third, in cases when the audit approach comprises mainly tests of controls, the auditor is instructed to gather more evidence about the effectiveness of controls. Unlike PCAOB standards, ISA 330 requires using evidence from prior audits about controls, and permits rotational testing of controls under specified conditions. Although both standard sets require the evaluation of operating effectiveness of controls and identified control deviations, only AS 13 demands the auditor to assess control risk in a specified way.

Unlike ISAs, AS 13 lists a series of factors to be considered for the determination whether to perform *interim substantive procedures*. Both standard sets demand the auditor to perform either substantive procedures or substantive procedures combined with tests of controls, to cover the period between the interim date and the end of the audit period. However, ISA 330.22 allows stand-alone substantive procedures, only if the auditor deems those to be "sufficient". In contrast to ISAs, AS 13 requires the comparison of relevant information at the interim date with that at the end of the period for identifying unusual amounts. Another unique requirement by AS 13 is that dual-purpose tests need to meet the objectives of tests of control and substantive tests.

In contrast to ISAs, AS 14.5 requires the performance of analytical procedures for *evaluating the auditor's conclusions*". Both, ISA 520.6 and AS 14.5, demand the performance of analytical procedures for assisting the auditor forming an overall opinion or conclusion respectively. Besides, the definitions of the overall conclusion and opinion differ.

As opposed to ISAs, AS 14.8 explicitly instructs the auditor to corroborate *management's explanations* concerning "significant unusual or unexpected transactions, events, amounts, or relationships". Moreover, ISA 450 requires the auditor to ask the management to correct all misstatements accumulated during the audit, whereas AS 14 focuses more on the communication of misstatements and the determination and evaluation of (un)corrected misstatements. Unlike ISAs, AS 14 demands a determination whether risk assessments remain appropriate, given the evaluation of accumulated misstatements.

Regarding the selection of items for *sampling*, the wording differs between the two standard sets. AS 15.22 requires the assessment whether the means of selecting items for "testing" are "sufficient", whereas ISA 500.10 demands the determination whether the means for "tests of controls and tests of details" are "effective".

2.1.4 Auditor's Responsibilities Regarding Fraud

The following standards were compared:

- ISA 240, ISA 315, ISA 330, ISA 450, ISA 500, ISA 520, ISA 540, ISA 700
- AS 12, AS 13, AS 14, AS 15

Both standard sets demand *professional scepticism*, but the scope of application differs. According to AS 13.7, the auditor needs to exercise professional scepticism "in response to risks of material misstatements". Additionally, this standard indicates examples for appropriate application. However, ISA 240.12 requires professional scepticism "throughout the audit", including the recognition that fraud could exist, irrespective of past honesty and integrity of the management.

The *authentication of documents* is not required neither in ISAs nor in PCAOB standards; however, whenever modifications or falsifications are indicated, further investigations are required. ISA 240.13 weakens this requirement for the protection of the auditor by allowing to accept documents as genuine "[u]nless the auditor has reason to believe the contrary".

While ISA 240 explicitly demands a *discussion among engagement team members*, as well as the engagement partner to determine which matters need to be communicated to team members not participating the discussion, AS 14 only requires the latter procedure though with emphasis on fraud risks. As opposed to ISAs, AS 14 includes the requirement of continuous communication among engagement team members throughout the audit about significant issues that affect risks of material misstatements.

2.1.5 Consideration of Fraud in a Statutory Audit

The following standards were compared:

- ISA 240, ISA 315, ISA 330, ISA 450, ISA 520, ISA 540, ISA 700
- AS 12, AS 14

ISAs do not include the following two requirements analogous to AS 12 regarding *fraud risk factors*. First, a discussion among engagement team members about how fraud might be committed or hidden, and an evaluation of these fraud risk factors is demanded. Second, an assessment of an identified control deficiency as an indicator for a fraud risk factor has to be performed. AS 12 lists a more extensive list of specified inquiries of the audit committee and management than ISA 240, which only specifies those regarding fraud. Unlike ISAs, AS 12.58 instructs the auditor to consider that management is "often in the best position to commit fraud" for the evaluation of management responses regarding fraud risks. Furthermore, the standard requires focusing on inconsistencies in those responses.

Both standard sets demand evaluations of *implications for fraud*. However, only AS 14 explicitly requires obtaining further evidence through audit procedures in order to see the effect of fraud on the financial statements. In case an offsetting adjusting entry is identified, AS 14 instructs the auditor to assess the reasons why the previous misstatement has remained undetected and the implications on management's integrity and (fraud) risk assessments. Furthermore, risks of additional undetected misstatements need to be addressed. ISAs do not comprise comparable requirements.

While ISA 240 instructs the auditor to *communicate fraud* or indications of fraud to the management on a timely basis, AS 14 instructs the auditor to first assess his or her responsibility under specified U.S. rules and regulations before communicating to the management. Although both standard sets require an evaluation of management's corrections made in response, individual requirements differ from each other. AS 14 instructs the auditor to evaluate the appropriateness of recorded corrections and the existence of uncorrected misstatements. In contrast to PCAOB standards, ISA 450 demands additional audit procedures to determine whether misstatements remain upon request for correction. Though, an evaluation of appropriate correction is not required.

AS 14 and ISA 240 require the evaluation whether *bias in management's judgements* affects material misstatements. But only AS 14 standard includes the instruction for evaluating whether the fraud risk assessments and responses remain appropriate.

2.2 EC-MARC Comparison of ISAs with PCAOB Auditing Standards

2.2.1 Outline of the Comparison

The EC commissioned the Maastricht Accounting, Auditing and Information Management Research Centre (MARC) to perform an independent study evaluating differences between ISAs and PCAOB standards (Evaluation of the differences between International Standards on Auditing (ISA) and the standards of the US Public Company Accounting Oversight Board (PCAOB), 2009). The study's main objectives included the identification of "the main technical differences between the Clarified ISAs and PCAOB Auditing and Interim Standards"[51]. Moreover, a study focus was on the assessment of the impact of these differences on audit practice, and of financial statements user perceptions of audits, in case both sets of standards were to be applied. The publication involved only differences that either could have had "an impact on the audit", were "formal but substantive" without impacting the audit, or arose "due to the different context of the US and international audit market".[52] Multi-location engagements were not included in the comparison.

First, a comparative analysis of the standards was conducted, which was divided into nine topics, whereof the following three are relevant for this thesis:

- *Topic 3: Risk assessment and use of analytical procedures*
  This topic deals with risk assessments and analytical procedures performed to identify, assess and evaluate risks of material misstatements.
- *Topic 5: Audit risk model, audit planning, materiality and sampling*
  This topic deals with materiality, audit planning, responses to risks and audit sampling in regard to material misstatements.
- *Topic 6: Fraud; illegal acts and compliance with laws and regulations; related parties*
  This topic deals with material misstatements due to fraud, as well as illegal acts and related parties issues.

Second, the impact of the detected differences was assessed by international technical partners from each of the "Big Four" audit firms. The main focus was to assess the amount of extra work if PCAOB standards were to be applied in addition to the ISAs.

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[51] Confer *Maastricht Accounting, Auditing and Information Management Research Center* (2009), page 13.
[52] Confer *Maastricht Accounting, Auditing and Information Management Research Center* (2009), page 65.

Third, European capital market experts were consulted in order to assess whether (1) the differences of the two sets of standards were perceived as important, and (2) dual auditing standards were perceived as beneficial by the European capital market. Overall, the experts concluded that there were "substantive"[53] differences in only five areas; whereof only "risk assessment and responses to assessed risks"[54] is relevant to this thesis. In this area the experts perceived that ISAs exceeded PCAOB standards. Moreover, the experts considered the combined application of both standard sets to offer "a slightly higher level of assurance"[55].

Detailed reviews of differences between the two sets of standards for topic 3, 5 and 6, are outlined separately according to the research team's comparative analysis and the experts' assessments in subsections 2.2.2 - 2.2.5. The impact of differences on audit practice found by the experts is summarised in the correspondent subsection 2.2.6. The subsections 2.2.2-2.2.6 only comprise the content of the EC-MARC study and no other opinion. However, subchapter 2.3 presents the opinion of the author of this thesis.

2.2.2 Risks of Material Misstatements

In topic 3, "Risk assessment and use of analytical procedures", the following standards were compared[56]:

- ISA 315 (HB 2008), ISA 330 (HB 2008), ISA 520 (Final)
- AU 312, AU 316, AU 329

Results of the comparative analysis show that ISAs, and in particular ISA 315, offer more direction on how to *identify risks* than the three PCAOB standards. Exempli gratia, provisions concerning risk assessment, as provided in ISA 315, do not exist in PCAOB standards. Moreover, ISA 315 stipulates the minimum considerations to determine which risks are significant, and is supplemented with a list of significant risks beyond fraud. According to ISA 315.28, auditors are required to "obtain an understanding of the entity's controls, including control activities relevant to" the identified significant risks. In contrast to ISAs, PCAOB standards do not introduce the term "significant risk".

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[53] Confer *Maastricht Accounting, Auditing and Information Management Research Center* (2009), page 67.
[54] Ibidem.
[55] Confer *Maastricht Accounting, Auditing and Information Management Research Center* (2009), page 109.
[56] The EC-MARC study clearly stated which version of ISAs they used. "HB 2008" stands for standards from Handbook 2008; "Final" implicates a "Clarified ISA". However, it has not been clearly specified which versions of the PCAOB standards were used.

While AU 329 sets *analytical procedures* to be used, not exclusively but also, to "assist the auditor in planning the nature, timing and extent of other audit procedures", ISA 330 directs the use of substantive procedures as a response to an assessed significant risk of material misstatements. Although the application and other explanatory material of ISA 315 describes the use of analytical procedures to assist the auditor in planning, it is not a requirement as it is according to AU 329. Additionally, unlike ISA 520, AU 329.10 requires the auditor to "evaluate the risk of management override of controls" and AU 329.16 to "test the design and operating effectiveness of controls over financial information" when performing analytical procedures. In return, ISA 520.A13 indicates that the auditor "may consider testing the operating effectiveness of controls". Hence, ISAs describe analytical procedures as a response to assessed risks, while PCAOB standards set the focus for analytical procedures more on evaluating and testing the effectiveness of internal controls.

Experts perceived ISAs to exceed PCAOB standards in terms of risk assessment and responses to assessed risks. However, they seized "little" differences among the two standard sets regarding analytical procedures.

2.2.3 Consideration of Material Misstatements in a Statutory Audit

In topic 5, "Audit risk model, audit planning, materiality and sampling", the following standards were compared:

- ISA 220 (Final), ISA 300 (HB 2008), ISA 315 (HB 2008), ISA 320 (Final), ISA 330 (HB 2008), ISA 450 (Final), ISA 530 (Final), ISQ 1 (Final)
- AU 311, AU 312, AU 313, AU 350, AS 5

Results of the comparative analysis show that AU 312 deals specifically with the relationships between analytical procedures and misstatements, as well as between sampling and projected misstatements. In contrast to AU 312, ISA 450 only comprises the latter relationship and only in the application and other explanatory material.

AU 311 discusses the nature, elements and factors that affect the extent of *supervision*. The application and other explanatory material of ISA 220, ISA 300 and ISA 315 offer some direction on supervision too, although not to such an extent as the PCAOB standards. Particular direction for matters that assistants should be informed about is not provided by the ISAs. Furthermore, AU 311, unlike ISAs, explicitly requires that the work performed by each assistant needs to be reviewed by the supervisor, and discusses the purpose of supervision. While both standard sets reference firm policies and procedures when concerned with differences of opinions, only AU 311.14

proposes procedures to "enable an assistant to document his disagreement with the conclusions reached".

Overall, ISA 330 provides more guidance on how the auditor shall respond to identified risks than AU 312. While ISA 330 requires the determination of *responses* at both, the financial statement and assertion levels, AU 312 only offers direction for the latter one. AU 313 explicitly lists factors that should be considered when deciding upon the performance of substantive tests at an interim date. Although the application and other explanatory material of ISA 330 also lists such factors, they differ "to some extent"[57] from those listed in AU 313. Moreover, AU 313 instructs the auditor to consider the necessary costs of substantive tests to cover the remaining period (exempli gratia the period from interim date until balance sheet date), whereas the application and other material of ISA 200 only generally addresses the weighing of costs and benefits.

In contrast to AU 350, ISA 530 offers auditors directions when considering an anomalous misstatement or a deviation discovered in a *sample*. More precisely, ISA 530.13 requires the auditor to "obtain a high degree of certainty that such misstatement or deviation is not representative of the population".

Experts perceived all the differences regarding topic 5 among the two standard sets as only "little".

2.2.4 Auditor's Responsibilities Regarding Fraud

In topic 6, "Fraud", the following standards were compared:

- ISA 240 (HB 2008), ISA 315 (HB 2008), ISA 330 (HB 2008)
- AU 316

Results of the comparative analysis show that, although both standard sets defined *procedures to detect fraud*, the sequence of them differs notably. ISA 240 instructs the auditor to first inquire involved individuals about inappropriate or unusual activities. Second, journal entries and other adjustments from the end of a reporting period have to be selected. Third, judgements and decisions made by management resulting in accounting estimates have to be evaluated, and it has to be decided whether to test them. AU 316.58 instructs the auditor to first "obtain an understanding of the entity's financial reporting process and the controls over journal entries and other adjustments"; second, to "identify and select journal entries and other adjustments for testing". Third, the timing of testing has to be determined, and fourth, involved individuals have to be

[57] Confer *Maastricht Accounting, Auditing and Information Management Research Center* (2009), page 63.

inquired about inappropriate or unusual activities. Compared to ISA 240, AU 316 provides more guidance in respect to the usage of *analytical procedures* and their inherent limitations in identifying risks of material misstatements due to fraud. However, the application and other explanatory material of ISA 240 gives comparable instructions.

Regarding *team discussion*, AU 316 is stricter than ISA 240 as it comprises more requirements. Particularly in accordance with AU 316.14-15, auditors are required to consider external and internal fraud risk factors, as well as the risk of management override of controls during the discussion among audit team members. However, the application and other explanatory material of ISA 240 provides a list of matters which may be included in the discussion. Contrary to ISAs, AU 316.74 includes the requirement that in respect to risks of material misstatements due to fraud "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".

Experts perceived all the differences regarding topic 5 among the two standard sets as only "little".

2.2.5 Consideration of Fraud in a Statutory Audit

In topic 6, "Fraud", the following standards were compared:

- ISA 240 (HB 2008), ISA 315 (HB 2008), ISA 330 (HB 2008)
- AU 316

Results of the comparative analysis show that the definition of *fraud risk factors* differs among the two standard sets. In addition to the incentives, pressure and opportunities to commit fraud listed by ISA 240, AU 316.31 also includes "attitudes/rationalizations to justify a fraudulent action" as indicating events or conditions. Though, in the application and other explanatory material of ISA 240, rationalisations are described as one of the three general conditions when fraud was committed. Notably, ISA 240.A25 states that rationalisation of fraudulent action "may not be susceptible to observation by the auditor".

AU 316 particularly requires the auditor to assess *risks of material misstatements* due to fraud throughout the audit, and to evaluate those risks at or near completion of fieldwork. Although ISA 315 and ISA 330 comprise comparable requirements, they do not explicitly refer to material misstatements "due to fraud"; the application and other explanatory material of ISA 240 refers the auditor in regard to the evaluation of assessed material misstatements due to fraud at the assertion level to ISA 330.

While ISA 240.44 requires the *documentation* of "significant decisions reached during the discussion among the engagement team" concerning material misstatements due to fraud, AU 316 requires the documentation of the engagement team discussion itself. AU 316 also specifies further documentation of procedures performed to identify and assess risks, of conditions and analytical procedures resulting in additional responses, as well as of those responses. In comparison to AU 316, ISA 315 instructs the documentation of performed risk assessment procedures, though not explicitly to identify risks of material misstatements "due to fraud".

Experts perceived all the differences regarding topic 5 among the two standard sets as only "little".

2.2.6 Impact of Differences on Audit Practice

International technical partners of each of the "Big Four" accounting firms (referred to as experts hereafter) were surveyed in order to examine the impact of differences between ISAs and PCAOB standards on audit practice. Particularly, they were asked what amount of extra work would be required, if both accounting sets had to be followed for an audit, id est the PCAOB standards in addition to ISAs.

Experts only found *extra work* in the stages of "completion of the audit" and "audit reporting". This can be explained by PCAOB standards' requirements for additional documentation, as well as for reporting on the effectiveness of internal control. ISAs only require the reporting of internal control for assessing the risk of material misstatements. The stage "risk evaluation" does not lead to extra work, because the requirements by ISAs are deemed exceeding those of PCAOB.

An *impact on risk evaluation procedures* causing additional work was only identified regarding "tests of controls". This impact can be explained by PCAOB standards requiring audits of internal control integrated with audits of financial statements. The experts perceived no further significant impact resulting from differences between the two standard sets. ISAs were considered to exceed PCAOB standards in respect to "Procedures to understand the client's environment". No impact on tests of accounting information could be found; detected differences were perceived by experts to be only "little".

The experts had conflicting views on the *impact on risk reduction.* Two of the experts perceived no reduction of risk of undetected material misstatements when following both standard sets. The other two experts found that following PCAOB standards in addition to ISAs would result in a "moderate" risk reduction due to additional requirements for auditing internal controls.

Overall, experts considered the audit approach instructed by ISAs to be more risk- and principles-based compared to PCAOB standards. The experts had conflicting views on the extent of guidance and precision, as well as need of auditor judgement. PCAOB standards may require more procedures and a greater documentation burden, but most of the additional requirements are included in ISA guidance material. Another explanation is that solely PCAOB standards demand integrated audits of internal control. Most importantly, the experts concluded that following PCAOB standards in addition to ISAs would not result in a different audit opinion.

2.3 Differences between the PCAOB and EC-MARC Comparisons

In general, the two comparisons used different standards and/or versions of standards (see table below). Hence, some differences arose due to different versions being compared. Unlike the PCAOB comparison, the one by the EC-MARC also included the application and other explanatory material of ISAs. The PCAOB included multi-location audits in its comparison, whereas the EC-MARC analysis did not. While the PCAOB compared its new standards to the ISAs, the EC-MARC study aimed to highlight the differences and the impact of these on EU companies cross-listed in the U.S. Hence, the latter one included expert opinions on the assessed differences.

Table 1: Standards used for PCAOB and EC-MARC Comparisons

PCAOB Comparison[58]	EC-MARC Comparison[59]
ISA 200, ISA 220, ISA 240	ISA 220 (Final), ISA 240 (HB 2008)
ISA 300, ISA 315	ISA 300 (HB 2008), ISA 315 (HB 2008),
ISA 320, ISA 330	ISA 320 (Final), ISA 330 (HB 2008)
ISA 450	ISA 450 (Final)
ISA 500, ISA 520, ISA 540	ISA 520 (Final), ISA 530 (Final)
ISA 600, ISA 700	ISQ 1 (Final)
AS 8-15 (2010)	AU 311, AU 312, AU 313
AU 330	AU 316, AU 329, AU 350

Source: *Public company Accounting Oversight Board* (2010), SEC Filing – PCAOB Rulemaking Docket Matter No. 026 2010; and *Maastricht Accounting, Auditing and Information Management Research Center* (2009).

Both comparisons found that ISAs provide more direction on how to identify *risk of material misstatements*. While the PCAOB perceived its own standards regarding risk assessment to be more strictly formulated, including more requirements and providing more information on sources, the EC-MARC study did not list this difference. The comparisons had contradicting opinions in respect to significant risks. While the

[58] Which versions of the standards were used for the comparison has not been clearly stated by the PCAOB. The new standards AS 8-15 were those released in the year 2010.

[59] The EC-MARC study clearly stated which version of ISAs they used. “HB 2008” means standards from Handbook 2008; “Final” implicates a “Clarified ISA”. However, it has not been clearly specified which versions of the PCAOB standards were used.

PCAOB perceived the definition of “significant risk” to differ between the two standard sets, the EC-MARC study stated that only ISAs use the term “significant risk” and provide minimum considerations for the determination of it. Only the PCAOB study named differences regarding obtainment of *understanding companies* and internal control between the two standard sets; the PCAOB standards include more requirements and ISAs provide additional guidance. The comparisons hold very conflicting views concerning the performance of *substantive procedures* according to ISAs. The PCAOB comparison stated that substantive procedures for material accounts and disclosures need to be performed regardless of the assessed risks, whereas the EC-MARC study described substantive procedures as responses to assessed significant risks.

Regarding *materiality*, only the PCAOB comparison found three differences. First, the wording and specification differs slightly. Second, merely PCAOB standards require the consideration of material misstatements identified during prior audits. Third, the perspective for revising materiality differs between the two standard sets. Furthermore, PCAOB comparison perceived the ISAs to limit *audit procedures* to the assertion level and that only AS 9 requires an audit plan and audit documentation explicitly. Both comparisons agreed that the PCAOB standards offer more direction on and options for *supervising* the engagement team. According to the PCAOB comparison, the objectives of *responses* to risks of material misstatements differ between the two standard sets. Furthermore, PCAOB standards provide more guidance and include more requirements on responding to risks than ISAs. In contrast to the PCAOB analysis, the EC-MARC study concluded that ISAs provide more guidance on responding to risks, and that PCAOB standards only offer direction on responding to risks at the assertion level. While the EC-MARC study perceived ISAs to “require” responses at the financial statement and assertion level, the PCAOB comparison concluded that ISAs “limit” responses to these two levels. The latter one also determined that the requirement for external confirmation *procedures* differs between the two standard sets. While PCAOB standards “require” these procedures, ISAs demand the auditor to “consider” them. Both comparisons found that PCAOB standards offer more guidance and include more requirements concerning interim substantial procedures. The PCAOB comparison noted the difference with respect to *communicating material misstatements*. Apart from ISAs demanding to request the management to correct communicated misstatements, PCAOB standards include more requirements. Regarding *sampling*, the PCAOB comparison noted different wording, whereas the EC-MARC study perceived ISAs to be stricter and to provide guidance opposed to PCAOB standards.

The PCAOB comparison concluded that the scope of *professional scepticism* differs between the two standard sets. Moreover, it deemed ISAs' requirements concerning *document authentication* as weaker. Both comparisons agreed that PCAOB standards comprise more and stricter requirements regarding engagement team discussions.

According to the EC-MARC study the definition of *fraud risk factors* in the two standard sets differ from each other. The PCAOB comparison did not indicate this difference. However, it concluded that PCAOB standards comprise more requirements and offer more directions for *inquiring* the audit committee and management than ISAs. The EC-MARC study recognised differences in timing when *assessing risks* of material misstatements. Whereas the PCAOB comparison noted those timing differences in connection with responses to risks as well as the evaluation of evidence. The PCAOB comparison determined further differences concerning *responses to risks of fraud.* First, PCAOB standards include more requirements for assessing and evaluation implications of fraud. Second, the communication of fraud is also referenced to the U.S. jurisdiction to be checked with. Third, the evaluation of misstatements corrections serve different purposes. Moreover, the PCAOB found the requirement for evaluating *bias of management* only in PCAOB standards. The EC-MARC comparison concluded that the PCAOB standards comprise more requirements regarding *audit documentation*.

The differences in assessments might arise from different standards and/or versions of standards, as well as on the focus of attention. During the time between the EC-MARC study and the PCAOB comparative analysis, as well as between the latter and today, old PCAOB standards have been superseded and ISAs have been modified. Chapters 3 and 4 present a comprehensive comparative analysis of the differences introduced in this chapter. The comparative analyses presented in this chapter have been comprehensive, and the amendments of the standards do not appear to diverge from each other, but rather to converge to each other; this is supported by the fact that the PCAOB annexed a 50-page comparison of its new and amended standards with ISAs. Hence, no replication of the comparative analyses has been indicated and the new analysis focuses on the differences introduced in this chapter. The analysis includes the application and other explanatory material of ISAs, and excludes multi-location engagements. The versions used for the comparison are the Clarified ISAs from the "2010 Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements", as well as the ASs and AUs published in Docket 026 or effective for the fiscal year 2011. Furthermore, the implications of the remaining differences for EU statutory auditors who have to apply both standard sets are discussed at the end of each subchapter.

3 Material Misstatements

3.1 Risks of Material Misstatements

3.1.1 Comparison of ISAs with PCAOB Standards

3.1.1.1 Risk Assessment

3.1.1.1.1 Understanding the Company

Both standard sets list *external sources* to be considered when obtaining an understanding of the company. However, they differ to some extent. On one hand, AS 12.11 lists inter alia transcripts of earnings calls, compensation arrangements with senior management, and trading activities in the company's securities and by significant holders. On the other hand, ISA 315.A5 lists regulatory publications, inquiries of external legal counsels or valuation experts. ISA 315.A24 includes stock-based compensation as an example of "unusual or complex transactions" to be considered when obtaining an understanding of the company.

ISAs do not include an analogous requirement to AS 12.8 which instructs the auditor to "evaluate whether significant changes in the company from *prior periods* […] affect the risks of material misstatements" when obtaining an understanding of the company. However, ISA 315.9 demands the auditor to "determine whether changes have occurred since the previous audit" in case the auditor plans to use information obtained from past experience with the company. ISA 315.A12 states that the auditor's previous experience may contain information about significant changes since the prior financial period "which may assist the auditor in gaining a sufficient understanding of the entity to identify and assess risks of material misstatements".

Although both standard sets require the auditor to understand the entity's *risk assessment process*, the exact requirements differ from each other. ISA 315.16 also demands the understanding of the risk assessment process' results and provides further directions in case the management failed to identify risks which the auditor identified. AS 12.26 instructs the auditor to understand the management's process for "assessing the likelihood and significance of misstatements resulting from" the identified risks. AS 12.27 requires understanding "the actions taken to address" the identified risks. Moreover, unlike PCAOB standards, ISA 315.17 offers guidance if the company has no risk assessment process or just an ad hoc one.

AS 12.29 explicitly instructs the auditor to understand "*how IT affects* the company's flow of transactions". Compared to AS 12, ISA 315.18 (b) requires the understanding

“of the information system” and the procedures within IT for initiating, recording, processing, correcting, transferring and reporting transactions. Furthermore, ISA 315.A54 states that controls in IT affect the above mentioned processes of transactions.

3.1.1.1.2 Understanding Internal Control

ISA 315.29 clearly requires the understanding of the entity’s controls “relevant” to existing significant risks. By comparison, AS 12.72 demands an evaluation of the design of entity’s controls which are “intended to address fraud risks and other significant risks”. AS 12.20 states that understanding internal control comprises the evaluation of controls “relevant to the audit”.

ISA 315.12 demands understanding of internal control “relevant to the audit”. Although AS 12.18 requires “sufficient” understanding of “each component of internal control”, AS 12.20 states that the understanding includes the evaluation of the design of controls “that are relevant to the audit”.

Both standard sets require an understanding of *control activities*, however, the specifications of the individual paragraphs differ from each other. ISA 315.20 instructs the auditor to obtain an understanding “relevant to the audit” and to “judge” whether it is “necessary to understand in order to assess the risks”. By comparison, AS 12.34 demands an understanding that is “sufficient to assess the factors that affect the risks” and the use of “knowledge” obtained from understanding other internal control components for “determining the extent to which it is necessary to devote additional attention”. ISA 315.A92 comprises the use of knowledge to “assist the auditor” in judging the need of additional attention.

Under both standard sets the understanding of internal control comprises the understanding of the *control environment*. AS 12.24 includes three required assessments for the understanding of the control environment; first whether “management’s philosophy and operating style promotes internal control”; second, the development and understanding of “sound integrity and ethical values”; and third, the understanding and exercising of “oversight responsibilities” by the board or audit committee. ISA 315.14 (b) demands the understanding of the control environment and references inter alia to 315.A70 for further direction. ISA 315.A70 (a), (c), (d), and (f) include assessments analogous to the three required by AS 12.24 as described above.

AS 12.39 and AS 12.40 instruct the auditor to consider “evidence obtained from understanding internal control” for *control risk assessments*, forming an opinion about internal control effectiveness, and determination of procedures “necessary to support

the auditor's conclusions" respectively. ISAs do not include comparable requirements. However, ISA 315.A42 states that understanding internal control "assists the auditor in identifying" potential misstatements and risk affecting factors, as well as in designing further audit procedures.

3.1.1.1.3 Identification of Risks

Although both standard sets require the *identification and assessment* of risks of material misstatements to serve as a basis for responses, the wording differs. While AS 12.3 links "assess" with "appropriately", ISA 315.3 specifies the risks by adding "whether due to error or fraud" and "at the financial statement and assertion levels". In addition, responses to the "assessed" risks set the frame of the requirement. Moreover, ISA 315.3 defines how to achieve the objective, by including "through understanding the entity and its environment". Even though it is not under the "objective" of the standard, AS 12.4 contains the phrase "whether due to error or fraud" too.

AS 12.44 explicitly instructs the auditor to evaluate whether information obtained during the review of *interim financial information* is relevant to identify risks of material misstatement. Although ISAs do not contain a general requirement comparable to AS 12.44, ISA 240.A22 states that information obtained from other engagements as reviewing interim financial information "may be relevant" for identifying risks of material misstatements "due to fraud". While AS 12.45 requires the auditor to take into account information obtained by the auditor or affiliates of the firm during the performance of *other engagements* for identifying risks, ISA 315.8 limits this requirement to other engagements performed by the engagement partner only.

Unlike ISAs, AS 12 introduces the term "*significant accounts and disclosures*" and includes further requirements in connection with the identification of risks of material misstatements. AS 12.60 demands the identification of significant accounts and disclosures and their relevant assertions, as well as the evaluation of risk factors related to them. AS 12.61 requires the determination of likely sources of potential misstatements as part of the identification process. AS 12.62 states that the significant accounts and disclosures and their relevant assertions are the same for audits of financial statements and of internal audits. Hence, the risk factors evaluated are the same for both audits.

Both standard sets require the consideration (ISA 315.7) and alternatively the evaluation (AS 12.41) whether "information obtained from the auditor's *client acceptance or continuance process* is relevant" for the identification of risks of material misstatements. ISA 315.9 demands the determination whether changes "that may

affect the relevance" of information – obtained from previous experience with the entity or audits – have occurred since the obtainment. AS 12.42 instructs the auditor to incorporate knowledge from past audits when identifying risks or "determining how changes affect the risks". Furthermore, AS 12.43 states that if the auditor plans to limit risk assessment procedures because he or she relies on information of past audits, the auditor "should evaluate whether the prior years' information remains relevant and reliable".

AS 12.59 (c) requires an evaluation "how risks at the financial statement level could *affect risks* of misstatement at the assertion level". Although ISAs do not include a comparable requirement, AS 315.A105 states that risks of material misstatements at the financial statement level "may increase the risks of material misstatement at the assertion level". Furthermore, ISA 315.A109 adds that the auditor "may conclude" that identified risks at the assertion level "relate more pervasively to the financial statements as a whole and potentially affect many assertions".

3.1.1.1.4 Significant Risks

Although both standard sets *define* a "significant risk" as a risk of material misstatements that requires special audit consideration, the exact wording differs. Under the definition section of AS 12, AS 12.A5 has no add-ons. In contrast to AS, ISA 315.4 (e) links risk with "identified and assessed" and adds "in the auditor's judgment" to the special audit consideration requirement. However, AS 12.70 also states that "the auditor should evaluate whether the risk requires special audit consideration" when determining the significance of "an identified and assessed risk".

Both standard sets, particularly ISA 315.27 and AS 12.59 (f), require the *determination* of significance of identified and assessed risks. However, ISA 315.27 adds the phrase "in the auditor's judgement" to the requirement.

Also regarding guidance for determining significant risks, both standard sets include similar *factors* but with different wording. While ISA 315.28 states that the auditor "shall consider at least" the listed factors, AS 12.71 demands the factors to "be evaluated". Both list the risk "related to recent significant economic, accounting or other developments", however, only ISA 315.28 (b) narrowed it further by adding "therefore, requires specific attention". Another difference in wording exists concerning financial information related to risk; ISA 315.28 (e) lists the "degree of subjectivity in the measurement", whereas AS 12.71 (f) lists the "degree of complexity or judgment in the recognition or measurement". Unlike ISAs, AS 12.71 (g) specifies transactions that appear unusual with the term "due to their timing, size, or nature". Furthermore, the

factor listed under AS 12.71 (a) regarding the effect of risk factors is not included in ISA 315.28.

3.1.1.2 Analytical Procedures

Both standard sets, and ISA 315.5 and AS 12.4 in particular, require the performance of *risk assessment procedures* that "provide a basis for" the identification and assessment of risks of material misstatements. AS 12.4 refines this requirement with the specifications of "procedures that are sufficient" to provide a "reasonable basis", and "whether due to error or fraud". Moreover, these risk assessment procedures should provide a basis for designing further audit procedures. Although ISA 315.5 does not include these refinements, ISA 315.4 (d) has incorporated the phrase "whether due to fraud or error" in the definition of risk assessment procedures. ISA 315.25 instructs the auditor to "identify and assess risks to provide a basis for designing and performing further audit procedures". Furthermore, ISA 315.5 limits the risks of material misstatements to "the financial statement and assertion level". Although AS 12.4 does not include this limitation, AS 12.59 does.

AS 12.5 offers more guidance regarding *factors* influencing risks of material misstatements and performing audit procedures to identify those risks than ISA 315.6. However, ISA 315.11 and the application and other explanatory material of ISA 315, in particular ISA 315.A17-A41, provide detailed guidance for these matters in addition.

Unlike ISAs, AS 14.7 explicitly instructs the auditor to perform analytical procedures *relating to revenue* "through the end of the reporting period". ISA 240.22 demands analytical procedures "including those related to revenue accounts" in case the auditor identifies "unusual or unexpected relationships". ISA 315.A7 states that analytical procedures may include financial and non-financial information. None of the standard sets specifically determines analytical procedures to assist the auditor in planning.

Both standards, ISA 330.21 and AS 13.11, require substantive procedures "*specifically responsive*" to assessed significant risks. However, only ISA 330.21 limits these risks of material misstatements to the assertion level.

Unlike ISAs, AU 329.10 explicitly demands the evaluation of the "risk of *management override of controls*". ISA 240.31-33 deal with audit procedures responding to the risk of management override of controls. ISA 240.31 states that an override risk is a significant risk of material misstatements; ISA 240.32 lists audit procedures to be performed "irrespective" of assessed risks of management override of controls; furthermore, ISA 240.33 requires the determination whether other procedures need to be performed in addition to those listed in ISA 240.32.

AU 329.16 instructs the auditor to “test the design and *operating effectiveness of controls*” or to “perform other procedures to support the completeness and accuracy of the underlying information” before the results from substantive analytical procedures are used. By comparison, ISA 330.8 requires the obtainment of “sufficient appropriate audit evidence” about the operating effectiveness of “relevant” controls through tests of controls, if the auditor intended to rely on the effectiveness. In case substantive procedures alone “cannot provide sufficient appropriate audit evidence”, tests of controls need to be performed. Furthermore, ISA 520.A13 states that the auditor “may consider” testing the operating effectiveness of controls in case the auditor has used information prepared by the entity for performing substantive analytical procedures.

AS 12.55 demands the use of knowledge about the company, its environment and from other risk assessment procedures for determining “the nature of the *inquiries* about risks of material misstatements”. ISAs do not include a comparable requirement.

Only the PCAOB standards introduce the term “*detection risk*”. AS 8.11 demands an increase of obtained evidence with a decrease of an “appropriate level of detection risk”. However, ISA 330.A15 and ISA 330.A19 also deal with this inverse relationship between risks of material misstatements and the extent of audit procedures, although in a less strict form using the phrase “may be appropriate”.

Regarding the data to be tested by *substantive procedures*, the wording between the two standard sets differs. ISA 330.18 requires substantive procedures “for each material class of transaction, account balance, and disclosure”, “irrespective of the assessed risks”. AS 13.36 requires these procedures “for each relevant assertion of each significant account and disclosure”, “regardless of the assessed level of control risk”.

ISA 200.17 and AS 8.3 demand “reasonable assurance” through “sufficient appropriate audit evidence”. However, the level to which the audit risk needs to be reduced is defined differently. ISA 200.17 requires “an acceptably low level”, while AS 8.3 indicates the level to be “appropriately low”.

3.1.2 Differences between ISAs and PCAOB Standards

3.1.2.1 Risk Assessment

Although both standard sets, and ISA 315.A5, ISA 315.A24 and AS 12.11 in particular, list external sources to be considered when obtaining an understanding of the company, they differ to some extent. Regarding significant changes in the company from past periods, the wording between ISA 315.9, ISA 315.A12 and AS 12.8 varies.

The exact requirements under ISA 315.16-17 and AS 12.26-27 for understanding the entity's risk assessment process differ. Moreover, ISA 315.17 offers more guidance than the comparable PCAOB standards. The exact wording for understanding IT effects between ISA 315.18 (b), ISA 315.A54 and AS 12.29 differs.

There are differences between ISA 315.20, ISA 315.A92 and AS 12.34 regarding the wording in the requirements for understanding control activities. Although the requirements section of ISA 315 does not comprise the same requirements regarding understanding the control environment like AS 12.24, the application and other explanatory material under 315.A70 includes them. Unlike ISAs, AS 12.39-40 require the auditor to consider evidence gathered from "understanding internal control" when performing control risk assessments, forming an opinion and determining necessary procedures for audit conclusions.

Identifying and assessing risks of material misstatements is expressed differently in ISA 315.3 and AS 12.3-4, respectively. While AS 12.44-45 explicitly instruct the auditor to evaluate whether information obtained from reviewing interim financial information is relevant for risk identification by the auditor or affiliates, ISA 240.A22 states that this information "may be relevant" and ISA 315.8 limits it to information obtained by the engagement partner only. Unlike ISAs, AS 12 introduces the term "significant accounts and disclosures" and AS 12.60-62 include further requirements in connection with the identification of risks of material misstatements. Although both standard sets include requirements regarding the relevance of information obtained from the auditor's client acceptance or continuance process for the risk identification, the wording between ISA 315.7, ISA 315.9 and AS 12.41-43 differs. In comparison to ISAs, only PCAOB standards and in particular AS 12.59 (c) requires an evaluation how risks of material misstatements at the assertion level could be affected by risks at the financial statement level.

Significant risks are differently defined in ISA 315.4 (e) and AS 12.5, AS 12.70 in terms of expression but not in regard to content. ISA 315.27 and AS 12.59 (f) use similar words for the requirement to determinate the significance of identified and assessed risks. The factors for determining significant risks included in ISA 315.28 are as well formulated differently than those in AS 12.71.

3.1.2.2 Analytical Procedures

The objective of risk assessment procedures between ISA 315.5 and AS 12.4 also differs only in regard to wording, particularly when considering ISA 315.4, ISA 315.25 and AS 12.59. Although AS 12.5 offers more guidance regarding factors influencing

risks and audit procedures than ISA 315.6 and ISA 315.11, the application and other explanatory material of ISA 315 provides detailed guidance on these matters in A17-A41 too. ISA 240.22 and AS 14.7 require the performance of analytical procedures relating to revenue; however, only ISA limits the requirement to certain conditions. Although ISA 330.21 and AS 13.11 require substantive procedures specifically responsive to assessed significant risks, only ISA limits these risks to the assertion level. While ISA 240.31-33 deal with audit procedures responding to risks of management override of controls, solely AU 329.10 explicitly demands the evaluation of these risks. Regarding obtained audit evidence about the operating effectiveness of controls, the wording between ISA 330.8 and AU 329.16 differs. Unlike ISAs, AS 12.55 demands using knowledge about the company and its environment as well as from other risk assessment procedures for determining the nature of inquiries about risks. In comparison to ISAs, PCAOB standards introduce the term “detection risk”; AS 8.11 requires an inverse relationship between obtained evidence and the level of detection risk. By comparison, ISA 330.A15 and ISA 330.A19 deal with the same inverse relationship, although in other words. In regard to the content to be tested by substantive procedures, the wording between ISA 330.18 and AS 13.36 differs.

The level to which the audit risk needs to be reduced is defined differently between ISA 200.17 and AS 8.3. ISA 200.17 requires “an acceptably low level”, while AS 8.3 indicates the level to be “appropriately low”.

3.1.2.3 Synopsis of the Differences

This table presents the differences discussed in 3.1.1 and summarised in 3.1.2. In order not to be redundant with the above subsections, only a brief description of the differences is presented in this table. For detailed description of the differences see 3.1.1.

The differences in the table are divided into differences in terminology and differences in content. Furthermore, differences in content are subdivided by 1) excluding and 2) including the application and other explanatory material of ISAs. These differentiations help emphasising that some differences in content only exist when ignoring the non-binding section of ISAs, and others persist even when considering this section. Differences in terminology are solely a matter of interpretation.

Table 2: Differences in Risks of Material Misstatements between ISAs and PCAOB Standards in Terms of Risks of Material Misstatements

Topic	Differences in *terminology*, *including* application and other explanatory material of ISAs	Differences in *content*, *excluding* application and other explanatory material of ISAs	Differences in *content*, *including* application and other explanatory material of ISAs
Risk Assessment			
Understanding the Company	-	List of external sources to be considered	List of external sources to be considered
	Requirement to evaluate whether significant changes from prior periods affect risks of material misstatements	Requirement to evaluate whether significant changes from prior periods affect risks of material misstatements	-
	-	Requirements to understand the entity's risk assessment process	Requirements to understand the entity's risk assessment process
	Requirement to understand how IT affects the company's transaction flow	-	-
Understanding Internal Control	Requirement to understand control activities	-	-
	Requirement to understand the control environment	Requirement to understand the control environment	-
	-	Requirement to understand internal control for assessing control risk	Requirement to understand internal control for assessing control risk
Identification of Risks	Requirement to identify and assess risks as a basis for responses	-	-
	-	Requirement to evaluate the relevance of information from reviewing interim financial information	Requirement to evaluate the relevance of information from reviewing interim financial information
	-	Term "Significant accounts and disclosures" and related requirements	Term "Significant accounts and disclosures" and related requirements
	Requirement to evaluate the relevance of information from the client acceptance or continuance process	-	-
	-	Requirement to evaluate how risks at the financial statement level affect risks at the assertion level	Requirement to evaluate how risks at the financial statement level affect risks at the assertion level
Significant Risks	Definition of the term "significant risk"	-	-
	Requirement to determine the significance of risks	-	-
	List of factors for determining significant risks	-	-
Analytical Procedures			
Analytical Procedures	Requirement to perform risk assessment procedures	-	-
	List of factors influencing risks and the performance of audit procedures to identify those risks	List of factors influencing risks and the performance of audit procedures to identify those risks	-

	-	Requirement to perform analytical procedures relating to revenue	Requirement to perform analytical procedures relating to revenue
	-	Requirement to perform substantive procedures responsive to assessed significant risks	Requirement to perform substantive procedures responsive to assessed significant risks
	-	Requirement to evaluate the risk of management override of controls	Requirement to evaluate the risk of management override of controls
	Requirement to test the design and operating effectiveness of controls	-	-
	-	Requirement to use knowledge for determining the nature of inquiries	Requirement to use knowledge for determining the nature of inquiries
	Term “detection risk” and related requirements	Term “detection risk” and related requirements	
	Requirement on what to be tested by substantive procedures	-	-
	Level to which the audit risk needs to be reduced	-	-

Source: own illustration.

3.1.3 Implications of Differences for Statutory Auditors in the EU

Differences which only exist in terminology between the two standard sets bear no direct implications for statutory auditors, except that in different jurisdictions different terms might be differently interpreted. Such a discussion is, however, not subject of this thesis. For further discussion on differences in terminology see “Appendix 10 – Additional Discussion of Auditing Standards, Amendments to PCAOB Standards, and Comments on Reproposed Standards” and for all Comment Letters Exhibit 2 of the Dock 026 SEC-Filing document. Furthermore, differences in content – apart from the application and other explanatory material of ISAs – can bear direct implications for the statutory auditor in case the auditor would not follow these instructions when applying ISAs anyway. However, a discussion whether statutory auditors in the EU strictly follow the application and other explanatory material of ISAs is not part of this thesis. Implications of differences in content between the two standard sets for statutory auditors in the EU (hereafter “auditors”) applying PCAOB standards in addition to ISAs are discussed here.

The difference in the list of external sources which need to be considered when obtaining an *understanding of the company* implicates that auditors applying PCAOB standards in addition to ISAs need to consider more external sources than when just applying ISAs. Regarding differences in understanding the entity’s risk assessment process, the requirements and guidance in ISAs exceed those in AS and hence, do not entail any implication for auditors. Although the application and other explanatory material of ISAs include a statement that *understanding internal control* assists the auditor, ASs explicitly instruct the auditor to consider evidence obtained from

understanding internal control for assessing control risk, forming an opinion and determining procedures. Therefore, ASs imply an additional obligatory requirement the auditor needs to comply with. Furthermore, only ASs explicitly require the evaluation of the relevance of information obtained by the auditor and affiliates during reviewing interim financial information for *identifying risks*. Although the application and other explanatory material of ISAs note that this information may be relevant, the AS requirement constitutes another requirement in addition to ISAs. Since only ASs introduce the term “significant accounts and disclosures”, all requirements related to that term are add-ons to the requirements that need to be complied with by applying ISAs. A further requirement by ASs is the evaluation how risks at the financial statement level could affect risks of misstatement at the assertion level – a requirement that ISAs do not include.

While ISAs instruct the performance of *analytical procedures* relating to revenue in case unusual or unexpected relationships have been identified, ASs demands the performance regardless of any conditions. Hence, this difference implicates another additional requirement for auditors in case no unusual or unexpected relationship had been identified. Since only ISAs limit substantive procedures responsive to assessed significant risks to the assertion level, ASs include a further requirement. Although ISAs state that the risk of management override of controls is a significant risk, only the PCAOB standard set explicitly requires the evaluation of this risk. Hence, auditors need to meet another requirement in addition to ISAs. Another requirement by ASs is the use of knowledge for determining the nature of the inquiries about risks.

Overall, the PCAOB standard set includes more requirements than ISAs in regard to understanding internal control, identification of risks, and analytical procedures. The differences relating to significant risks do not entail any implications for auditors because they only constitute of differences in terminology. Furthermore, a more extensive list of external sources needs to be considered when obtaining an understanding of the company. Considering the assessment of experts from the EC-MARC study and the fact that some of the differences presented in the previous comparisons have been refuted, the remaining differences between the two standard sets seem only little.

3.2 Consideration of Material Misstatements in a Statutory Audit

3.2.1 Comparison of ISAs with PCAOB Standards

3.2.1.1 Materiality

Both standard sets, particularly ISA 320.10 and AS 11.6, require a determined *materiality level* "for the financial statement as a whole". AS 11.6 adds the phrase "that is appropriate in light of the particular circumstances". In addition, the standard demands the level being "expressed as a specified amount". ISA 320.10 does not include these requirements, but it instructs the auditor to determine materiality levels for "classes of transactions, account balances or disclosures" for which already misstatements of lower amounts than those defined for the financial statement as a whole "could reasonably be expected to influence the economic decisions of users".

While ISA 320.11 requires the determination of "*performance materiality*", AS 11.8 requires the determination of "*amounts of tolerable misstatements*". Apart from using different terms, the purpose and the associated requirements are the same. ISA 320.A12 demands the amounts being set to "reduce the probability" of that the "aggregate of uncorrected and undetected misstatements" exceeding materiality level for the financial statements as a whole, to an appropriately low level. By contrast, AS 11.8 states that "tolerable misstatements should be less than the materiality level". Both, ISA 320.A12 and AS 11.9, instruct the auditor to consider the nature and extent of misstatements from past audits for determining performance materiality and tolerable misstatements, respectively. However, on one hand, only AS 11.9 adds the "cause of misstatements" to be considered. On the other hand, ISA 320.11 states that determining performance materiality "involves the exercise of professional judgement".

Regarding the revision of materiality levels, the perspective of who would be affected by a different level differs. ISA 320.12, particularly when taking into account ISA 320.A13 too, demands a revision in case changes in circumstances or, changes in the auditor's understanding of the entity and its operations, or in case new information "would have caused the auditor to have determined a different amount (or amounts) initially". In comparison, AS 11.11 instructs the auditor to reevaluate materiality levels in case levels differing "significantly" from initial ones due to changes in circumstances or in case additional information "would influence the judgment of a reasonable investor".

3.2.1.2 Audit Planning and Performing

3.2.1.2.1 Audit Strategy and Audit Plan

The two standard sets demand the audit to be planned. ISA 300.9 states that the auditor "shall develop an *audit plan*", whereas AS 9.4 instructs the auditor to "properly plan the audit".

ISA 300.9 and AS 9.10 specify the *content* of the audit plan. While ISA 300.9 (b) limits "further audit procedures" to "the assertion level", AS 9.10 (b) incorporates no such limitation. Though, AS 9.10 (b) specifies these procedures as "tests of controls and substantive procedures".

Unlike ISAs, AS 9.10 explicitly requires the auditor to *document the audit plan*. Although not stating it as explicitly as the PCAOB standard, ISA 300.12 lists matters that the auditor "shall include in the audit documentation".

3.2.1.2.2 Audit Supervision

ISA 220.15 states that the engagement partner is responsible for directing, supervising and performing the audit. The application and other explanatory material under ISA 220.A13-A15 offer further direction on each responsibility. In comparison to ISAs, AS 10.5 requires the auditor to inform, direct and review the work of engagement team members, as well as includes guidance on how to meet these requirements.

Although both, ISA 220.A13 and AS 10.5, provide direction on matters the engagement partner needs to *inform the team members* about, they differ to some extent. ISA 220.A13 includes the "objectives of the work" and the "detailed approach to the performance", while AS 10.5 lists the "objectives of the procedures" and the "nature, timing, and extent of procedures". ISA demands the information about the "nature of the entity's business", "[r]isk-related issues", and "problems that may arise". However, under AS 10.6 the engagement partner needs to inform team members about "[m]atters that could affect the procedures […] including relevant aspects of the company, its environment, and its internal control over financial reporting". Unlike the PCAOB standard, ISA 220.A13 requires the engagement partner to inform team members of "[t]heir responsibilities, including the need to comply with relevant ethical requirements, and to plan and perform an audit with professional skepticism" and "of respective partners where more than one partner is involved". However, AS 10.5 (b) instructs the engagement partner to direct team members to point out significant issues and to apply due professional care.

Unlike ISAs, AS 10.4 offers the engagement partner the option to "*seek assistance* from appropriate engagement team members" for his or her supervisory responsibilities. It further notes that the requirements of AS 10 regarding supervisory responsibilities have to be met by engagement team members assisting in supervising the team. In contrast to AS, ISA 220.A16 states that "work of less experienced team members is reviewed by more experienced team members".

Both standard sets, and in particular ISA 220.16 and AS 10.5, require the *work of the engagements team members to be reviewed* by the engagement partner. ISA 220.A17 and AS 10.5 provide guidance in regard to the content of the review, including performance and documentation of the work, the achievement of the procedures' objectives and the support of reached conclusions by the evidence. Besides different wording, only ISA 220.A17 includes considerations whether "significant matters have been raised for further consideration", and whether "appropriate consultations have taken place and the resulting conclusions have been documented and implemented".

Although ISA 300.A14 and AS 10.6 list factors to be considered when determining the *extent of supervision*, the standards are not completely the same. While ISA 300.A14 includes the "size and complexity of the entity", AS 10.6 does not limit the company factors to size and complexity, but included them to "the nature of the company". ISA 300.A14 lists the "area of the audit" and AS 10.6 the "nature of the assigned work" refining them as the "procedures to be performed" and the "controls or accounts and disclosures to be tested". In contrast to AS 10.6, ISA 300.A14 limits the risks of material misstatements to the "assessed risks". ISA 300.14 focuses on the "capabilities and competence" of individual team members, whereas AS 10.6 lists the "knowledge, skill, and ability" of team members to be considered.

In contrast to ISAs, the PCAOB standard set requires the engagement team members to document their disagreement with the final audit conclusion. AS 10.5 (b) notes that "each engagement team member has a responsibility to bring to the attention of appropriate persons, disagreements or concerns". AS 3.12 (d) states that "[if] an engagement team member disagrees with the final conclusions reached, he or she should document that disagreement". By comparison, ISA 220.22 instructs the engagement team to "follow the firm's policies and procedures for dealing with and resolving differences of opinion".

3.2.1.3 Auditor's Responses to Risks of Material Misstatements

3.2.1.3.1 Overall Responses to Risks

The *objective* of auditor's responses to risks differs between the two standard sets. ISA 330.3 defines the objective as "to obtain sufficient appropriate audit evidence" regarding the assessed risks through "appropriate responses". In comparison to ISA, AS 13.2 defines the objective as "to address the risks" through "appropriate overall responses and audit procedures".

ISA 330.5 instructs the design and implementation of overall responses *addressing assessed risks* "at the financial statement level". Furthermore, ISA 330.6 comprises a similar instruction to "design and perform further audit procedures" but for assessed risks "at the assertion level". AS 13.5 requires the designing and implementation of overall responses addressing assessed risks, without limiting them to any level.

Guidance on overall responses is included in the application and other explanatory material of ISA 330, particularly in A1-A8. The PCAOB standard provides guidance on overall responses, especially in AS 13.5-7.

Unlike ISAs, AS 13.6 explicitly instructs the determination whether "*pervasive changes* to the nature, timing, or extent of audit procedures" are necessary in order to "adequately address the assessed risks". Furthermore, AS 13.6 lists increasing "substantive testing" at year-end and obtaining "more persuasive audit evidence" as examples of modifying the audit strategy. In comparison to AS, ISA 330.A1 lists as possible overall responses "to address the assessed risks" inter alia "general changes to the nature, timing or extent of audit procedures" which include the performance of "substantive procedures at the period end" and the obtainment of "more persuasive audit evidence".

Both standard sets deal with *external confirmation procedures*; however, the requirements differ from each other. ISA 330.19 requires the auditor to "consider" whether to perform external confirmation procedures as substantive procedures. "AU 330: The Confirmation Process" provides guidance on the identically called topic, but AU 330.02 references the auditor regarding the extent of these procedures to AS 13. AS 13.36 instructs the performance of substantive procedures "for each relevant assertion of each significant account and disclosure".

3.2.1.3.2 Tests of Controls

AS 13.9 (c) demands that the objectives of both audits, audit of financial statement and of internal control, are accomplished simultaneously when performing an *integrated*

audit. ISAs do not cover integrated audits and therefore do not include a comparable requirement to AS 13.9 (c).

ISA 330.9 and AS 13.18 both require “more persuasive audit evidence” from tests of controls, “the greater the *reliance* […] *on the effectiveness of a control*”. AS 13.18 further specifies the evidence to be obtained “for each relevant assertion for which the audit approach consists primarily of tests of controls”, comprising situations in which stand-alone substantive procedures “cannot provide sufficient appropriate audit evidence”. In comparison to AS 13.18, ISA 330.A25 states that a “higher level of assurance may be sought” when the adopted approach “consists primarily of test of controls” and “it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures”.

Both standards sets, and in particular ISA 330.10, ISA 330.A27 and AS 13.19, demand audit evidence to be obtained about the *persons operating the company’s controls*. ISA 330.10 instructs the auditor to obtain audit evidence about “by whom or by what means” the controls were applied. Furthermore, ISA 330.A27 requires that evidence also has to be sought about the “assignment of authority and responsibility”. Compared to ISA, AS 13.19 instructs the auditor to determine whether persons operating controls possess “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”.

ISA 330.13 and AS 13.31 require the auditor to consider specified factors when determining whether to use *audit evidence from past audits* about operating effectiveness. However, these factors differ between the two standards to some extent. Apart from wording differences, only ISA 330.13 lists “the lack of a change in a particular control” and whether it “poses a risk due to changing circumstances”. While ISA includes the “effectiveness of other elements of internal control, including the control environment, the entity’s monitoring of controls, and the entity’s risk assessment process”, AS 13.31 includes the “effectiveness of entity-level controls that the auditor has tested, especially controls that monitor other controls”. Unlike ISAs, AS 13.31 covers the assessment of whether “there have been changes in the volume or nature of transactions”, and “whether the account has a history of errors”, as well as “the competence of the personnel who perform the control or monitor its performance”. Furthermore, “the nature, timing, and extent of procedures performed in past audits” have to be assessed, as well as “whether there have been changes in the control or the process in which it operates since the previous audit”; and “evidence regarding the

effectiveness of the controls obtained during the audit of internal control" for integrated audits has to be gathered.

Regarding rotational testing, ISA 330.13 states that the auditor shall determine "the length of the time period that may elapse before retesting a control" by considering the above mentioned factors. Furthermore, ISA 330.14 requires testing controls "at least once in every third audit" and "some controls each audit". The PCAOB standards do not include comparable requirements or the option for rotational testing.

Although ISA 330 and AS 13 cover the assessment of control risk, the requirements differ to some extent. AS 13.32 requires the evaluation of evidence from tests of controls obtained during the audit of financial statements and internal control, detected misstatements and identified control deficiencies. Whereas ISA 330.16 and ISA 330.A40 require the evaluation of whether detected misstatements "indicate that controls are not operating effectively" and that "[a] significant deficiency in internal control" exists respectively. ISA 330.17 demands specific inquiries to understand deviations from controls and their potential consequences in case the auditor plans to rely on these controls. Furthermore, the auditor needs to determine whether performed tests of controls "provide an appropriate basis for reliance on the controls", the necessity of additional tests of controls, and the need of address potential risks through substantive procedures. By comparison, AS 13.34 instructs the auditor to "evaluate the severity of the deficiencies and the effect on the auditor's control risk assessments. The auditor is required to perform "tests of other controls" and to "[r]evise the control risk assessment and modify the planned substantive procedures as necessary". Unlike ISAs, AS 13.33 demands the control risk assessment to 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".

3.2.1.3.3 Interim Substantive Procedures

Although both standard sets list *factors* to be considered when determining whether to perform interim substantive procedures, they differ to some extent. Unlike ISA, AS 13.44 further defines assessed risk of material misstatements. While under ISA 330.A56 the "purpose" of substantive procedures needs to be considered, it is the "nature" of substantive procedures under AS 13.44. The PCAOB standard lists the ability to perform "necessary audit procedures to cover the remaining period". In comparison to AS, ISA 330.A56 refines this factor by defining audit procedures as "appropriate substantive procedures or substantive procedures combined with tests of

controls" and adds "to reduce the risk that misstatements that may exist at the period end will not be detected". Unlike AS 13.44, ISA further lists the control environment and other relevant controls, as well as the availability of necessary information at "a later date".

Both, ISA 330.22 and AS 13.45, demand the performance of *stand-alone* substantive procedures or substantive procedures *combined with tests of controls* to cover the remaining period between the interim date and the period end. Only ISA stated that a stand-alone substantive procedure is to be performed when the auditor determines it to be "sufficient". Besides, ISA.A55 and AS 13.45 require comparing information from the interim date with that of the period end, identifying and investigating amounts "that appear unusual", and testing intervening or remaining period respectively. While AS 13.45 demands the comparison of "relevant information about the account balance" and the performance of "audit procedures" for the testing, ISA 330.22 instructs the auditor to compare "and reconcile" information "concerning the balance" and specifies the performance of "substantive analytical procedures or tests of details".

ISA 330.A23 states that the auditor "may design" a *dual-purpose test* on a transaction and "may accomplish" both purposes separately – the purpose of a test of controls and of a test of details. Furthermore, ISA provides an example of designing and evaluating the results of such a test. In comparison to ISA, AS 13.47 declares dual-purpose test as which the auditor "might perform" in "some situations". The objectives of both tests need to be achieved. Unlike ISA, AS 13.47 explicitly instructs the auditor to "evaluate the results of the test".

The application and other explanatory material of ISA 200, and in particular A48, discuss the *balancing of time and cost*, as well as the value of liable information and cost. The PCAOB standards do not include anything comparable.

3.2.1.3.4 Evaluation of Audit Results

Both, ISA 520.6 and AS 14.5, require the analytical procedures to assist the auditor in forming an *overall conclusion* and *opinion* respectively. However, the overall conclusion under ISA 520.6 needs to cover whether the financial statements are "consistent with the auditor's understanding of the entity". ISA adds that the procedure shall be performed "near the end of the audit". In comparison to ISAs, under AS 14.5 an opinion on whether the financial statements "as a whole are free of material misstatements" is requested. AS 14.5 also states that analytical procedures should be performed to "evaluate the auditor's conclusions formed regarding significant accounts and disclosures".

Unlike ISAs, AS 14.8 explicitly instructs the auditor to "obtain corroboration for *management's explanations* regarding significant unusual or unexpected transactions, events, amounts, or relationships". In case management's responses to inquiries appear implausible, inconsistent with audit evidence, imprecise or not sufficient, further procedures to address the matter need to be performed. In comparison to AS, ISA 500.A23 states that responses to inquiries "might provide information that differs significantly from other information" and in some cases "provide a basis for the auditor to modify or perform additional audit procedures". ISA 520.A21 notes that the auditor needs to perform other audit procedures when "management is unable to provide an explanation, or the explanation […] is not considered adequate".

Although both standard sets, and in particular ISA 450.8 and AS 14.15, require *communication of accumulated misstatements* on a timely basis, the purpose of the communication and the subsequent specified approaches differ. ISA 450.8 demands the auditor to communicate detected misstatements, "unless prohibited by law or regulation", and then to "request management to correct those misstatements". Whereas AS 14.15 requires communication of misstatements in order "to provide management with an opportunity to correct them". In case management examined and corrected misstatements upon request, ISA 450.7 instructs the performance of "additional audit procedures" for determining "whether misstatements remain". AS 14.16 also demands the determination whether uncorrected misstatements remain after management has made corrections in response. However, only under AS 14.16 the auditor needs to evaluate management's work for determining "whether the corrections have been recorded properly" too. AS 14.17 requires the evaluation whether "uncorrected misstatements are material, individually or in combination with other misstatements". Additionally, the standard notes the interpretation of the terms "material" and "determinations of materiality" from the Supreme Court of the United States.

AS 14.19 instructs the auditor to evaluate "nature and effects of the individual misstatements accumulated" and determine whether "*the risk assessments remain appropriate*". In comparison to AS 14.19, ISA 330.A61 requires the auditor to consider "how the detection of a misstatements affects the assessed risks" and to determine whether "the assessment remains appropriate".

3.2.1.4 Audit Sampling

Regarding selecting items for tests of controls and tests of details, the two standard sets define the *means of selecting items* for testing differently. ISA 500.10 demands the means to be "effective in meeting the purpose of the audit procedure". AS 15.22 states

that the means of item selection should be “sufficient to meet the objective of the audit procedure”.

Unlike PCAOB standards, ISA 530.13 provides guidance in case a discovered misstatement or deviation in a sample is considered “an *anomaly*”. The standard requires the auditor to “obtain a high degree of certainty” that this anomaly is “not representative of the population”. Furthermore, ISA 530.13 instructs additional audit procedures for “sufficient appropriate audit evidence” that the anomaly does “not affect the remainder of the population”. By comparison, AU 350.24 demands the sample to be selected that it can be “expected to be representative of the population”.

3.2.2 Differences between ISAs and PCAOB Standards

3.2.2.1 Materiality

The requirements regarding determining a *materiality* level in ISA 320.10 and AS 11.6 differ in wording, in a way that they focus on different aspects. While ISA 320.11 requires the determination of “performance materiality”, AS 11.8 requires the determination of “amounts of tolerable misstatements”. Apart from using different terms, the purpose and the associated requirements are the same.

Regarding the revision of *materiality levels*, the perspective of who would be affected by a different level differs. While ISA 320.12 and ISA 320.A13 demand a revision in case the auditor would have determined a different level initially, AS 11.11 instructs the auditor to reevaluate materiality levels in case a reasonable investor would be influenced by a different level.

3.2.2.2 Audit Planning and Performing

The formulation of the requirement to *plan the audit* is not identical between ISA 300.9 and AS 9.4. Regarding what the audit plan needs to include, only ISA 300.9 limits further audit procedures to the assertion level, whereas AS 9.10 specifies these procedures as tests of controls and substantive procedures. Unlike ISAs, AS 9.10 explicitly requires the auditor to document the audit plan, whereas ISA 300.12 lists matters which the auditor shall include in the audit documentation.

Wording between ISA 220.15-16, ISA 220.A13-A15 and AS 10.5 for the engagement partner’s *supervisory responsibilities* differs. Although both, ISA 220.A13 and AS 10.5, provide direction on matters the engagement partner needs to inform the team members about, they differ to some extent. Unlike ISAs, AS 10.4 offers the engagement partner to seek assistance from engagement team members for his or her supervisory responsibilities. Besides different formulations between ISA 220.A17 and

AS 10.5 regarding reviewing the work of the engagements team members, only ISA 220.A17 includes considerations of significant matters and appropriate consultations and the resulting conclusions. Although ISA 300.A14 and AS 10.6 list factors to be considered when determining the extent of supervision, they are not completely matching. In contrast to ISAs, AS 3.12 requires the engagement team member to document his or her disagreement with the final audit conclusion, while ISA 220.22 refers to firm's policies and procedures to be followed.

3.2.2.3 Auditor's Responses to Risks of Material Misstatements

The objective of auditor's responses to risks differs between ISA 330.3 and AS 13.2. Compared to AS 13.5, only ISA 330.5 and ISA 330.6 limit *overall responses* to the financial statement and assertion level respectively. The wording addressing risks by making changes to audit procedures differ between ISA 330.A1 and AS 13.6. The requirements regarding external confirmation procedures are as well different between ISA 330.19 and AS 13.36.

Unlike ISAs, AS 13.9 demands that the objectives of both audits, audit of financial statement and of internal control, are accomplished simultaneously when performing an integrated audit. Requirement for evidence on the effectiveness of a control from *tests of controls* are formulated differently between ISA 330.9, ISA 330.A25 and AS 13.18. The wording between ISA 330.10, ISA 330.A27 and AS 13.19 regarding audit evidence about the persons operating the company's controls varies. Factors which need to be considered when determining whether to use audit evidence from past audits about operating effectiveness differ between ISA 330.13 and AS 13.31 to some extent. Unlike PCAOB standards, ISA 330.13-14 include the option for rotational testing. The requirements for assessing control risk vary between ISA 330.16-17, ISA 330.A40 and AS 13.32-34.

Although both, ISA 330.A56 and AS 13.44, list *factors* to be considered when determining whether to perform *interim substantive procedures*, they differ to some extent. The wording for performing substantive procedures to cover the remaining period between the interim date and the period end differs between ISA 330.22 and AS 13.45. Besides different formulations on requirements for dual-purpose tests, only AS 13.47 explicitly instructs the auditor to evaluate the results of these tests. Unlike PCAOB standards, the application and other explanatory material in ISA 200.A48 discusses the *balancing of time and cost*, as well as the value of liable information and cost.

ISA 520.6 and AS 14.5 require the analytical procedures to assist the auditor in forming an overall conclusion and opinion, respectively. However, the requirements themselves differ. Unlike ISAs, AS 14.8 explicitly instructs the auditor to obtain corroboration for management's explanations. The requirements in case further audit procedures are needed due to management's responses to inquiries under ISA 500.A23 and ISA 520.A21 are formulated differently than under AS 14.8. Although ISA 450.8 and AS 14.15 require communication of accumulated misstatements on a timely basis, the purpose of the communication and the subsequent specified approaches differ. The wording regarding the evaluation of misstatements and of their effects on assessments differs between ISA 330.A61 and AS 14.19.

3.2.2.4 Audit Sampling

Regarding selecting items for tests of controls and tests of details, ISA 500.10 and AS 15.22 differently define the means of selecting items for testing. Unlike PCAOB standards, ISA 530.13 provides guidance in case a discovered misstatement or deviation in a sample is considered an anomaly.

3.2.2.5 Synopsis of the Differences

This table presents the differences discussed in 3.2.1 and summarised in 3.2.2. In order not to be redundant with the above subsections, only a brief description of the differences is presented in this table. For detailed description of the differences see 3.2.1. For a detailed explanation of the table see 3.1.2.3.

Table 3: Differences in Risks of Material Misstatements between ISAs and PCAOB Standards in Terms of Consideration of Material Misstatements in a Statutory Audit

Topic	Differences in *terminology*, *including* application and other explanatory material of ISAs	Differences in *content*, *excluding* application and other explanatory material of ISAs	Differences in *content*, *including* application and other explanatory material of ISAs
Materiality			
Materiality	Requirement to determine materiality level	-	-
	Requirement to determine performance materiality/tolerable misstatements	Requirement to determine performance materiality/tolerable misstatements	-
	-	Perspective of who would be affected by a different materiality level	Perspective of who would be affected by a different materiality level
Audit Planning and Performing			
Audit Strategy and Audit Plan	Requirement to plan the audit	-	-
	-	Limitations regarding required content of the audit plan	Limitations regarding required content of the audit plan
	Requirement to document the audit plan	-	-

Audit Supervision	Supervision responsibilities of the engagement partner	Supervision responsibilities of the engagement partner	-
	-	List of matters the engagement partner needs to inform the team members about	List of matters the engagement partner needs to inform the team members about
	-	Option to seek assistance for supervisory responsibilities	Option to seek assistance for supervisory responsibilities
	-	Guidance on the requirement to review the work of the engagement team members	Guidance on the requirement to review the work of the engagement team members
	-	List of factors for determining the extent of supervision	List of factors for determining the extent of supervision
	-	Requirement to document a team member's disagreement with the final audit conclusion	Requirement to document a team member's disagreement with the final audit conclusion
Auditor's Responses to Risks of Material Misstatements			
Overall Responses to Risks	-	Objective of auditor's responses to risks	Objective of auditor's responses to risks
	-	Level of the assessed risks to be addressed through overall responses	Level of the assessed risks to be addressed through overall responses
	Requirement to determine whether pervasive changes of audit procedures are necessary	Requirement to determine whether pervasive changes of audit procedures are necessary	-
	-	Requirements regarding external confirmation procedures	Requirements regarding external confirmation procedures
Tests of Controls	-	Requirement to accomplish objectives of both audits for an integrated audit	Requirement to accomplish objectives of both audits for an integrated audit
	Requirement for more persuasive evidence the greater the reliance on the effectiveness of a control	Requirement for more persuasive evidence the greater the reliance on the effectiveness of a control	-
	Requirement to obtain audit evidence about persons operating the company's controls	Requirement to obtain audit evidence about persons operating the company's controls	-
	-	List of factors for determining whether to use audit evidence from past audits	List of factors for determining whether to use audit evidence from past audits
	-	Option for rotational testing	Option for rotational testing
	-	Requirements for assessing control risk	Requirements for assessing control risk
Interim Substantive Procedures	-	List of factors for determining whether to perform interim substantive procedures	List of factors for determining whether to perform interim substantive procedures
	Requirement regarding substantive procedures to cover the remaining period	Requirement regarding substantive procedures to cover the remaining period	-
	-	Requirements regarding dual-purpose tests	Requirements regarding dual-purpose tests
	-	-	Consideration of balancing time and cost

Evaluation of Audit Results	-	Required content of overall conclusion and opinion	Required content of overall conclusion and opinion
	-	Requirement to obtain corroboration for management's explanations	Requirement to obtain corroboration for management's explanations
	Requirement to perform further procedures due to management's responses to inquiries	Requirement to perform further procedures due to management's responses to inquiries	-
	-	Purpose of communicating accumulated misstatements to management and subsequent approaches	Purpose of communicating accumulated misstatements to management and subsequent approaches
	Requirement to evaluate the effects of detected misstatements and appropriateness of assessments procedures	Requirement to evaluate the effects of detected misstatements and appropriateness of assessments procedures	-
Audit Sampling			
Audit Sampling	Definition of the means of selecting items for testing	-	-
	-	Guidance in case an anomaly is discovered in a sample	Guidance in case an anomaly is discovered in a sample

Source: own illustration.

3.2.3 Implications of Differences for Statutory Auditors

Implications of differences in content between the two standard sets for statutory auditors in the EU (hereafter "auditors") applying PCAOB standards in addition to ISAs are discussed as follows. For implications of differences in terminology see 3.1.3.

Regarding the revision of *materiality levels*, ISAs focus on the perspective of the auditor, whereas ASs focus on that of a reasonable investor. Hence, when applying both standard sets, the auditor needs to consider both perspectives.

Both standard sets specify what the *audit plan* needs to include. While ISAs specify the level, ASs specify the procedures. These specifications together further guide the auditor in regard to minimum requirements. The differences in the list of matters the engagement partner needs to inform the team members about, in connection with the partner's *supervisory responsibilities*, implicate more matters about which to inform team members. Since only ASs provide to the engagement partner the option to seek assistance for his or her supervisory responsibilities, this difference has no implications for the auditor because ISAs do not offer an analogous option and thus this option cannot be exercised. Besides different terminology regarding the requirement to review the work of the engagement team members when including the application and other explanatory material, ISAs exceed PCAOB standards and hence this requirement does not bear any implications for auditors. The difference in the list of factors which need to be considered when determining the extent of supervision implicates that auditors

applying PCAOB standards in addition to ISAs need to consider more factors than when just applying ISAs. Unlike ISAs, ASs requires the engagement team member to document his or her disagreement with the final audit conclusion. Therefore, ASs imply an additional obligatory requirement the auditor needs to comply with.

The objectives of auditor's *responses to risks* differ between the two standard sets and hence imply that both objectives need to be achieved. Unlike ISAs, ASs do not limit overall responses to address assessed risks at the financial statement and assertion levels. Thus, the auditor cannot limit the overall responses to those two levels when applying ASs too. Another additional requirement by ASs is the performance of substantive procedures for each relevant assertion of each significant account and disclosure. Because ISAs do not cover integrated audits, the requirement to accomplish objectives of both audits – audit of financial statement and audit of internal *control* – simultaneously implies a further requirement for auditors. The difference in the list of factors which need to be considered when determining whether to use audit evidence from past audits implicates that auditors applying ASs in addition to ISAs need to consider more factors than when just applying ISAs. Since only ISAs provide the option for rotational testing, this option cannot be exercised when applying both standard sets. Moreover, the requirements regarding the assessment of control risk differ to some extent and therefore imply additional requirements to comply with. The difference in the list of factors which needs to be considered when determining whether to perform *interim substantive procedures* implicates that auditors applying PCAOB standards in addition to ISAs need to consider more factors than when just applying ISAs. ASs and the application and other explanatory material of ISAs state that the auditor may perform a dual-purpose test, and ASs explicitly requires the evaluation of this test's results. Since both standard sets are rather vague in their formulations, the only implication for the auditor is that in case such a test has been performed the results need to be evaluated. Only the application and other explanatory material of ISAs discusses the balancing of time and cost and therefore, ISAs exceed ASs and this difference does not bear any implications for auditors. In case of *evaluating audit results*, the requirements differ regarding analytical procedures to assist in forming an overall conclusion and opinion. Hence, these differences entail additional requirements for the auditor to comply with. A further requirement to ISAs is to obtain corroboration for management's explanations regarding significant unusual or unexpected transactions, events, amounts or relationships. Altogether the requirements after communicating accumulated misstatements to the management of ISAs exceed those of the PCAOB and hence, do not entail any implications for auditors.

Regarding *sampling*, only ISAs provide guidance in case an anomaly has been discovered in a sample. Hence, ISAs exceed ASs concerning this matter and this difference does not bear any implications for auditors.

Overall, the PCAOB standard set includes more requirements than ISAs in regard to audit supervision and auditor's responses to risks of material misstatements, and ISAs provide more guidance on audit sampling. Furthermore, the auditor needs to consider the perspective of the auditor and a reasonable investor when determining whether to revise materiality levels. In regard to the required content of the audit plan, both standard sets include different specifications and combined provide more guidance than individually. More extensive lists of factors need to be considered when determining the extent of supervision, whether to use audit evidence from past audits, and whether to perform interim substantive procedures. The different options included in either ISAs or PCAOB standards are not applicable when applying both standard sets. Considering the assessment of experts from the EC-MARC study and the fact that some of the differences presented in the previous comparisons have been refuted, the remaining differences between the two standard sets seem only little.

4 Material Misstatements due to Fraud

4.1 Auditor's Responsibilities Regarding Fraud

4.1.1 Comparison of ISAs with PCAOB Standards

4.1.1.1 Responsibility for the Prevention and Detection of Fraud

Both standard sets, and in particular ISA 240.12, ISA 240.A7 and AS 13.7, require the auditor to exercise and maintain *professional scepticism*, meaning an "attitude that includes a questioning mind" and "a critical assessment" of audit evidence. AS 13.7 refines this by requiring the assessment of "the appropriateness and sufficiency" of audit evidence. ISA 240.12 demands the maintenance of professional scepticisms irrespective of the auditor's "past experience of the honesty and integrity" of the management, whereas AU 316.13 demands it irrespective of "any past experience with the entity" and "the auditor's belief about management's honesty and integrity". While ISA 240.12 instructs the auditor to "maintain" professional scepticism "throughout the audit", AS 13.7 instructs the "application" of it "in response to the assessed fraud risks". ISA 240.A7 emphasises the importance of professional scepticism "when considering the risks of material misstatements due to fraud". AU 230.8 states that professional scepticism "should be exercised throughout the audit process".

Neither ISA 240.13 nor AS 15.9 require the *authentication of documents* by the auditor. In case conditions indicate "that a document may not be authentic or that [the] terms in a document have been modified but […] not been disclosed" the auditor indeed needs to respond". ISA 240.13 instructs the auditor to "investigate further" with ISA 240.A9 providing examples for further investigations, and ISA 200.A21 to "determine what modifications or additions to audit procedures are necessary to resolve the matter". By comparison, AS 15.9 demands the auditor to "modify the planned audit procedures or perform additional audit procedures" and "evaluate the effect, if any, on the other aspects of the audit". Only IAS 240.13 weakens the auditor's responsibility in relation to authentic documents with the phrase "[u]nless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine". However, also AU 316 limits the auditor's responsibility. AU 316.9 states that the auditor "may not discover the existence of a modification of documentation"; AU 316.12 further states that the auditor may "rely unknowingly on audit evidence that appears to be valid, but is, in fact, false and fraudulent".

The *sequences of detection procedures* to "test the appropriateness of journal entries" specified in ISA 240.32 and AU 316.58 differ from each other. Under ISA 240.32 the

auditor shall first, “make inquiries of individuals”; second, “[s]elect journal entries and other adjustments made at the end of a reporting period”; and third, “[c]onsider the need to test journal entries and other adjustments throughout the period”. Whereas under AU 316.58 the auditor should first, “[o]btain an understanding of the entity’s financial reporting process and the controls over journal entries and other adjustments”; second, “[i]dentify and select journal entries and other adjustments”; third, “[d]etermine the timing of the testing”; and fourth, “[i]nquire of individuals involved in the financial reporting process about inappropriate or unusual activity”.

Both standard sets provide guidance on using analytical procedures for *assessing risks of material misstatement due to fraud*. ISA 240.22 and AS 12.47 require analytical procedures for identifying “unusual or unexpected relationships” which might “indicate” risks of material misstatements “due to fraud”. While ISA 315.A8 suggests analytical procedures to “identify the existence of unusual transactions or events, and amounts, ratios, and trends”, AS 12.46 instructs them. Both, ISA 315.A9 and AS 12.48, indicate that data “aggregated at a high level” only offers a “broad initial indication” and is “not designed with the level of precision necessary” respectively. Compared to PCAOB standards, only ISA 315.A7 notes that analytical procedures for assessing risks “may include both financial and non-financial information” and provided examples of such information. Unlike ISAs, AS 14.47 requires the consideration of analytical procedures performed for the review of “interim financial information”, if applicable. Furthermore, only AS 12.48 instructs the auditor to “use his or her understanding of the company to develop expectations about plausible relationships among the data to be used in the procedure”.

4.1.1.2 Engagement Team Discussion

Although ISAs and PCAOB standards require *discussions among engagement team members*, the requirements differ to some extent. ISA 240.15 demands a “discussion among the engagement team members” and that particularly emphasises on “how and where the entity’s financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur”. In contrast to ISA 240.15, AS 14.29 requires “communication […] regarding information or conditions that are indicative of fraud risks“.

Regarding *communication within the engagement team*, ISA 240.15 instructs the engagement partner to determine “which matters are to be communicated to those team members not involved in the discussion”. AS 12.50, on the other hand, states that “key engagement team members should communicate the important matters from the discussion to engagement team members who are not involved in the discussion”.

AS 14.29 explicitly requires the engagement partner to determine whether there has been *appropriate communication* "throughout the audit". ISAs do not include a comparable requirement.

4.1.2 Differences between ISAs and PCAOB Standards

4.1.2.1 Responsibility for the Prevention and Detection of Fraud

The requirements to exercise and maintain professional scepticism of ISA 240.12, ISA 240.A7 and AS 13.7, AU 280.3, AU 316.13 are formulated differently. Regarding document authentication, the terminology between ISA 240.13, ISA 240.A9, ISA 200.A21 and AS 15.9, AU 316.9, AU 316.12 varies. The sequence of detection procedures to "test the appropriateness of journal entries" specified in ISA 240.32 and AU 316.58 notably differs from each other.

Besides different formulations between ISA 240.22, 315.A8-9 and AS 12.46-48 for assessing risks of material misstatement due to fraud, ISA 315.47 provides more guidance on which information shall be included in analytical procedures. AS 12.47-48, on the other hand, include more requirements than ISAs.

4.1.2.2 Engagement Team Discussion

Although both, ISA 240.15 and AS 14.29, require discussions among engagement team members, the requirements differ to some extent. Regarding communication within the engagement team, the wording between ISA 240.15 and AS 12.50 varies. Unlike ISAs, AS 14.29 explicitly requires the engagement partner to determine whether there has been appropriate communication throughout the audit.

4.1.2.3 Synopsis of the Differences

This table presents the differences discussed in 4.1.1 and summarised in 4.1.2. In order not to be redundant with the above subsections, only a brief description of the differences is presented in this table. For detailed description of the differences see 4.1.1. For a detailed explanation of the table see 3.1.2.3.

Table 4: Differences in Risks of Material Misstatements between ISAs and PCAOB Standards in Terms of Auditor's Responsibilities Regarding Fraud

Topic	Differences in *terminology*, *including* application and other explanatory material of ISAs	Differences in *content*, *excluding* application and other explanatory material of ISAs	Differences in *content*, *including* application and other explanatory material of ISAs
Responsibility for the Prevention and Detection of Fraud			
Responsibility for the Prevention and Detection of Fraud	Requirement to exercise and maintain professional scepticism	-	-
	Responsibility in relation to document authentication	Responsibility in relation to document authentication	-

Topic	Differences in *terminology*, *including* application and other explanatory material of ISAs	Differences in *content*, *excluding* application and other explanatory material of ISAs	Differences in *content*, *including* application and other explanatory material of ISAs
	-	Sequence of detection procedures	Sequence of detection procedures
	-	Requirements to and guidance on using analytical procedures for assessing fraud risks	Requirements to and guidance on using analytical procedures for assessing fraud risks
Engagement Team Discussion			
Engagement Team Discussion	-	Requirements regarding communication within the engagement team	Requirements regarding communication within the engagement team
	Requirement to determine which matters are to be communicated to those not involved in the team engagement discussion	-	-
	-	Requirement to determine whether there has been appropriate communication	Requirement to determine whether there has been appropriate communication

Source: own illustration.

4.1.3 Implications of Differences for Statutory Auditors

Implications of differences in content between the two standard sets for statutory auditors in the EU (hereafter “auditors”) applying PCAOB standards in addition to ISAs are here discussed. For implications of differences in terminology see 3.1.3.

The sequence of *detection* procedures differs completely between the two standard sets – exempli gratia in ISAs, the inquiry of individuals is the first step and in PCAOB standards the last step. Hence, only one strategy can be chosen, which either entails no implications (ISAs) or a different strategy than usually pursued (PCAOB standards), depending on the rules and regulations of each jurisdiction. While ISAs provide more guidance on using analytical procedures for assessing risks of material misstatement due to fraud, ASs include more requirements. Therefore, additional requirements need to be complied with.

The requirements regarding the content of team engagement discussions differ between the two standard sets to some extent. Therefore, not only how and where financial statements may be susceptible, but also information and conditions that are indicative of fraud risks need to be discussed. Another additional requirement to ISAs is for the engagement partner to determine whether there has been appropriate communication within the team throughout the audit.

Overall, the PCAOB standard set includes more requirements than ISAs in regard to performing analytical procedures for fraud risk assessments, and appropriate communication within the engagement team. Since the prescribed sequence of detection procedures differs completely, the auditor needs to choose one. Moreover,

additional matters need to be discussed during the engagement team discussion. ISAs include more guidance on performing analytical procedures for fraud risk assessments. Considering the assessment of experts from the EC-MARC study and the fact that some of the differences presented in the previous comparisons have been refuted, the remaining differences between the two standard sets seem only little.

4.2 Consideration of Fraud in a Statutory Audit

4.2.1 Comparison of ISAs with PCAOB Standards

4.2.1.1 Fraud Risk Factors

Both, ISA 240.A25 and AU 316.7, define the same three *conditions* "generally present when fraud" occurs. These conditions are an "incentive or pressure", an "opportunity" to commit, and an ability to "rationalize" fraud.

Although both standard sets provide an extensive list of whom and about what to inquire, they differ to some extent. ISA 240.18-19, ISA 240.21 demand *inquiries* of "management", "and others within the entity as appropriate", "internal audit", and "those charged with governance" unless involved in managing, respectively. AS 12.54 requires inquiries of the "audit committee", "management", "internal audit function", "and others within the company who might reasonably be expected to have information that is important". Although ISA 240.17-18, ISA 240.A12 and AS 12.56 list the same matters for inquiring management and ISA 240.21, ISA 240.A19 and AS 12.56 for the audit committee, only AS 12.56 additionally lists an inquiry whether "tips or complaints" have been received by management or the audit committee. Unlike ISAs, AS 12.56 includes the performance of "procedures to identify or detect fraud during the year, and whether management has satisfactorily responded to the findings", and the awareness of "instances of management override of controls" for inquiring internal audit personnel. In contrast to PCAOB standards, ISA 240.A16 offers a list of other persons "within the entity to whom the auditor may direct inquiries".

ISA 240.A17 states that "[m]anagement is often in the *best position* to perpetrate fraud" and concludes that when the auditor evaluates management's responses to inquiries it "may" be necessary to corroborate these responses with "other information". Compared to ISAs, AS 12.58 instructs the auditor to "take into account the fact that management is often in the best position to commit fraud", and to "obtain evidence to address inconsistencies in responses to the inquiries".

AS 12.25 explicitly requires the auditor to "evaluate the extent" of which an identified *control deficiency* "is indicative of a fraud risk factor. Compared to AS 12.25,

ISA 240.24 demands an evaluation of "whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present". Moreover, ISA 240.24 references to ISA 240.A23 which states that a "control environment that is not effective may create an opportunity to commit fraud".

Both standard sets require the engagement team to *discuss fraud risk factors*. ISA 240.15 demands "particular emphasis on how and where the entity's financial statements may be susceptible to material misstatements due to fraud, including how fraud might occur". AS 12.52 instructs the key engagement team members to discuss "how management cold perpetrate and conceal fraudulent financial reporting, and how assets of the company could be misappropriated". Moreover, the application and other explanatory material of ISA 240, particularly A11, uses the exact same terminology as AS 12.52 cited above.

4.2.1.2 Responses to Risks of Material Misstatements due to Fraud

4.2.1.2.1 Responses to Assessed Risks

AS 12.74 explicitly demands a *continuing* "*assessment* of the risks of material misstatements, including fraud risks […] throughout the audit". ISAs do not include an analogous requirement.

Although both standard sets require the *evaluation of the effects of fraud*, the requirements between ISA 240.37, 450.3 and AS 14.21 differ to some extent. ISA 240.37 instructs the auditor to "evaluate the implications for the audit" if material misstatements due to fraud are confirmed or the auditor is "unable to conclude" about it. Furthermore, ISA 450.3 demands the evaluation of the "effect" of identified and of uncorrected misstatements on the financial statements. AS 14.21, on the other hand, requires the determination "whether fraud has occurred or is likely to have occurred and, if so, its effect on the financial statements" in case the auditor "believes that a misstatement is or might be intentional" and the "effect […] could be material or cannot be readily determined". In contrast to ISAs, AS 14.21 demands "additional audit evidence" for the determination.

In contrast to ISAs, AS 14.25 (b) provides guidance on responding to "*adjusting entries that offset misstatements* accumulated by the auditor". In case the auditor identifies such an adjusting entry, the standard requires a determination why the underlying misstatements was not identified previously, an evaluation of the implications on the management's integrity and on the risk assessments, as well as additional procedures addressing the "risk of further undetected misstatement".

4.2.1.2.2 Communication of Fraud

The requirements on what to *consider before communicating* identified fraud or indications for fraud differ between the two standard sets. ISA 240.40 and AU 316.79 require communication to the "appropriate level of management". However, only ISA 240.40 demands this communication "on a timely basis", and ISA 240.A60 "as soon as practicable". Unlike ISAs, AS 14.23 instructs the auditor to determine "his or her responsibilities" under U.S. law, particularly Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. § 78j-1. In comparison to the PCAOB standard set, ISA 260.7 states that "[l]aw and regulation may restrict the auditor's communication" and that "auditor's obligations of confidentiality and obligations to communicate may be complex". Therefore, the standard suggests to "consider obtaining legal advice" under such circumstances.

ISA 450.7 demands additional audit procedures for determining whether "*misstatements remain*" upon request. In comparison to ISA 450.7, AS 14.16 requires an evaluation of "management's work", inter alia whether corrections have been "recorded properly" and whether "uncorrected misstatements remain" in response to the auditor's communication of misstatements.

4.2.1.3 Evaluation of Audit Evidence and Audit Documentation

In case the auditor identifies "*bias in management's judgements*", AS 14.26 explicitly requires an evaluation whether the auditor's "assessment" of risks of material misstatements, particularly of fraud risks, and the "related audit responses" remain appropriate. In comparison to AS 14.26, ISA 540.A124 states that indicators of possible management bias "may affect the auditor's conclusion as to whether the auditor's risk assessment and related responses remain appropriate".

Only the PCAOB standard set clearly instructs the auditor to *document the engagement team discussion* itself without preconditions. ISA 240.44 demands the documentation of "significant decisions reached during the discussion" and of "identified and assessed risks of material misstatements due to fraud". Furthermore, ISA 315.32 requires the auditor to document the engagement team discussion "where required by paragraph 10", "significant decisions reached", "[k]ey elements of the understanding", performed risk assessment procedures, and identified and assessed risks. ISA 230.8 states that the auditor "shall prepare audit documentation" including performed audit procedures, results of these procedures, obtained audit evidence, as well as significant matters, reached conclusions and "significant professional judgments". In comparison to ISAs, AU 316.83 demands the documentation of the engagement team discussion, procedures for identifying and assessing fraud risks,

identified fraud risks, and "the linkage of those risks to the auditor's response". In addition, the auditor needs to document "reasons supporting the auditor's conclusion" that improper revenue recognition is not a fraud risk, results of procedures addressing fraud risks, "[o]ther conditions and analytical relationships", as well as the "nature of the communications about fraud" to the management.

4.2.2 Differences between ISAs and PCAOB Standards

4.2.2.1 Fraud Risk Factors

Although both standard sets, particularly ISA 240.17-19, ISA 240.21, ISA 240.A12, ISA 240.A16, ISA 240.A19 as well as AS 12.54 and AS 12.56, provide an extensive list of *whom and about what to inquire*, they differ to some extent. On one hand, AS 12.56 lists more matters to be inquired than ISAs, and on the other hand, ISA 240.A16 offers a list of other persons to whom the auditor may direct inquiries.

The terminology between ISA 240.A17 and AS 12.58 regarding the fact that management is often in the best position to commit fraud, and the corresponding instructions differ. Moreover, the requirements for identified control deficiencies as indictors for fraud risk factors are formulated differently in ISA 240.24, ISA 240.A23 than in AS 12.25. The only difference between ISA 240.15, ISA 240.A11 and AS 12.52 in regard to discussions about fraud risk factors among the engagement team is the terminology.

4.2.2.2 Responses to Risks of Material Misstatements due to Fraud

In contrast to ISAS, AS 12.74 explicitly demands a continuing assessment of the risks of material misstatements, including fraud risks throughout the audit. Although both standard sets require the evaluation of the effects of fraud, the requirements between ISA 240.37, ISA 450.3 and AS 14.21 differ in terminology. Furthermore, only AS 14.21 demands additional audit evidence for the determination of whether fraud has been committed and its effects on the financial statements. Unlike ISAs, AS 14.25 (b) provides guidance on responding to adjusting entries that offset misstatements accumulated by the auditor.

The requirements on the content to be considered before *communicating* identified fraud or indications for fraud differ between the two standard sets, particularly ISA 240.40, ISA 240.A60, ISA 260.7 and AU 316.79, AS 14.23. While ISA 450.7 demands a determination whether *misstatements remain* upon request, AS 14.16 requires an evaluation of whether corrections have been recorded properly and whether uncorrected misstatements remain in response to the auditor's communication of misstatements.

4.2.2.3 Evaluation of Audit Evidence and Audit Documentation

Unlike ISA 540.A124, AS 14.26 explicitly requires an evaluation whether the auditor's risk assessment and related audit responses remained appropriate in case the auditor identifies bias in management's judgements. The requirements regarding audit documentation vary between ISA 230.6, ISA 240.44, ISA 315.32 and AU 316.83; some are similar and both contain requirements not covered by the other standard set.

4.2.2.4 Synopsis of the Differences

This table presents the differences discussed in 4.2.1 and summarised in 4.2.2. In order not to be redundant with the above subsections, only a brief description of the differences is presented in this table. For detailed description of the differences see 4.2.1. For a detailed explanation of the table see 3.1.2.3.

Table 5: Differences in Risks of Material Misstatements between ISAs and PCAOB Standards in Terms of Consideration of Fraud in a Statutory Audit

Topic	Differences in *terminology*, *including* application and other explanatory material of ISAs	Differences in *content*, *excluding* application and other explanatory material of ISAs	Differences in *content*, *including* application and other explanatory material of ISAs
Fraud Risk Factors			
	-	List of whom and about what to inquire	List of whom and about what to inquire
	Requirement to consider that management is often in the best position to commit fraud	Requirement to consider that management is often in the best position to commit fraud	-
	Requirement for identified control deficiencies as indictors for fraud risk factors	Requirement for identified control deficiencies as indictors for fraud risk factors	-
	Requirement to discuss fraud risk factors	-	-
Responses to Risks of Material Misstatements			
Responses to Assessed Risks	-	Requirement to assess risks of material misstatements throughout the audit	Requirement to assess risks of material misstatements throughout the audit
	-	Requirements to evaluate the effects of fraud	Requirements to evaluate the effects of fraud
	-	Guidance on responding to adjusting entries that offset identified misstatements	Guidance on responding to adjusting entries that offset identified misstatements
Communication of Fraud	-	Requirements on what to consider before communicating fraud or indications for fraud	Requirements on what to consider before communicating fraud or indications for fraud
	-	Requirement to determine whether misstatements remain upon request/in response to the auditor's communication	Requirement to determine whether misstatements remain upon request/in response to the auditor's communication
Evaluation of Audit Evidence and Audit Documentation			
	-	Requirement to evaluate whether the risk assessment remains appropriate in case bias in	Requirement to evaluate whether the risk assessment remains appropriate in case bias in

Topic	Differences in *terminology*, *including* application and other explanatory material of ISAs	Differences in *content*, *excluding* application and other explanatory material of ISAs	Differences in *content*, *including* application and other explanatory material of ISAs
		management's judgement has been identified	management's judgement has been identified
	-	Requirements regarding audit documentation, including engagement team discussions	Requirements regarding audit documentation, including engagement team discussions

Source: own illustration.

4.2.3 Implications of Differences for Statutory Auditors

Implications of differences in content between the two standard sets for statutory auditors in the EU (hereafter "auditors") applying PCAOB standards in addition to ISAs are discussed as follows. For implications of differences in terminology see 3.1.3.

Regarding *fraud risk factors*, the difference in the list of whom and about what to inquire, implicates that auditors applying PCAOB standards in addition to ISAs need to inquire more matters than when just applying ISAs. Since only ISAs provides a list of "other persons" to inquire, this difference does not bear any implications for auditors.

The requirement for continuing assessment of the risks throughout the audit by ASs is an add-on to the requirements that need to be complied with by applying ISAs when *responding to assessed risks*. Furthermore, ASs' requirement to obtain additional audit evidence for determining the effects of fraud implies another requirement to ISAs. Only the PCAOB standard set includes a requirement regarding the response to adjusting entries that offset accumulated misstatements. Therefore, ASs includes an additional obligatory requirement the auditor needs to comply with. Regarding *communicating identified fraud* ISAs require communication on a timely basis and suggest obtaining legal advice in case law and regulation restrict this. The PCAOB standard set refers to U.S. law, which is not applicable for auditing EU companies and hence, this difference does not entail any implications for auditors. Since the requirement by ISAs to determine whether misstatements remain upon request exceed the equivalent of PCAOB standards, no implication arises from this difference for auditors.

In addition to ISAs, PCAOB standards requiret to *evaluate* whether the assessment of risks and related responses remain appropriate in case bias in management's judgement has been identified. Furthermore, only the PCAOB standard set demands the *documentation* of the engagement team discussion itself without preconditions. This requirement implies that the auditor needs to document the discussion itself anyhow. Additional documentation is only implicated if not required by ISAs anyway.

Overall, the PCAOB standard set includes more requirements than ISAs in regard to responses to assessed risks, as well as in regard to evaluation of audit evidence and audit documentation. ISAs, in turn, comprise more requirements than PCAOB standards relating to communication of fraud, which do not bear any implications for auditors. Furthermore, more matters need to be inquired under the PCAOB standard set. Considering the assessment of experts from the EC-MARC study and the fact that some of the differences presented in the previous comparisons have been refuted, the remaining differences between the two standard sets seem only little.

5 Conclusion

The comparative analysis in chapters 3 and 4 shows that ISAs generally provide more guidance for auditors on how to perform the audit, and PCAOB standards comprise more requirements regarding material misstatements. Particularly, PCAOB standards include more requirements than ISAs in regard to ten important areas, namely understanding internal control, identification of risks, analytical procedures, audit supervision, auditor's responses to risks of material misstatements, performing analytical procedures for fraud risk assessments, communication within the engagement team, responses to assessed risks, evaluation of audit evidence, and audit documentation. ISAs provide more guidance on audit sampling and performing analytical procedures for fraud risk assessments, and contain more requirements regarding the communication of fraud. Both standard sets include various lists of differing factors to consider during an audit in regard to understanding the company, audit supervision, tests of controls, interim substantive procedures, engagement team discussion, and fraud risk factors. The options for audit supervision and tests of controls, which are each only provided by one of the two standard sets, are not applicable when complying with both. Therefore, EU statutory auditors applying PCAOB standards in addition to ISAs need to fulfil more requirements and to consider more factors regarding material misstatements due to error or fraud during an audit. The new comparison shows that the Clarity Project by the IAASB and Docket 026 by the PCAOB have reduced the differences between the two standard sets.

The PCAOB and EC-MARC comparisons both show strengths and weaknesses. While the first one is very detailed regarding the new PCAOB standards AS 8-15, it is less transparent where ISAs are concerned and ignores the application and other explanatory material of ISAs. The EC-MARC comparison includes the application and other explanatory material, clearly states which standards and paragraphs have been compared, but uses earlier versions of standards which are not applicable anymore. Furthermore, both comparisons are slightly biased to their own standard set. Hence, by incorporating both comparisons, the new analysis in this thesis tries to balance these biases out. Although the two comparisons have been carried out by experts, the versions of standards used are not those currently enforced. Therefore, basing the new comparative analysis on their findings rather than comparing all standards again does not preclude that all differences have been covered; although it is rather improbable, differences could have remained undetected at first hand or new differences could have emerged due to amendments in the standard sets.

Although I deem the implications of differences as only little, I think that the overall outcome of an audit that meets both standard sets could be of higher quality rather than of inferior one. Furthermore, the PCAOB standards are not differing from ISAs to such a high degree that the additional work load of the requirements per se would overstrain the auditor or would be excessively time-consuming. However, since one standard set is already complex, the comparison and filtering out of the differences between the two standard sets for applying both simultaneously is even more complex and time-consuming than complying with only one set. Therefore, I think that having to apply two different standard sets – even with little implications of differences – is not an optimal condition for the long-run. The additional costs, time and complexity are not in relation to the benefits arising from the compliance of both standard sets. A possible future solution for this situation of dual auditing standards would be that the Security and Exchange Commission (SEC) of the U.S. also accepts audits in compliance with ISAs, analogous to the SEC's acceptance in regard to accounting. In 2007, the SEC adopted a rule under the "International Series Release No. 1306". This rule enables the SEC to accept financial statements from foreign private issuers prepared in accordance with International Financial Reporting Standards (IFRS) and has become effective on March 8, 2008. As a next step, the SEC is considering to allow financial statements prepared in accordance with IFRS by U.S. issuers,[60] which would be a recommendable future development for ISAs as well.

[60] Confer SEC File No. S7-27-08.

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7 Appendices

Appendix 1: Standards Used for the Comparative Analysis in Chapters 3 and 4

ISA	AS (AU)
RISKS OF MATERIAL MISSTATEMENTS **Risk Assessment: Understanding the Company**	
315.9 Where the auditor intends to use information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits, the auditor shall determine whether changes have occurred since the previous audit that may affect its relevance to the current audit. (Ref: Para. A12–A13) **315.A12** The auditor's previous experience with the entity and audit procedures performed in previous audits may provide the auditor with information about such matters as: • Past misstatements and whether they were corrected on a timely basis. • The nature of the entity and its environment, and the entity's internal control (including deficiencies in internal control). • Significant changes that the entity or its operations may have undergone since the prior financial period, which may assist the auditor in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement. **315.A25** Significant changes in the entity from prior periods may give rise to, or change, risks of material misstatement.	**12.8** In obtaining an understanding of the company, the auditor should evaluate whether significant changes in the company from prior periods, including changes in its internal control over financial reporting, affect the risks of material misstatement.
315.16 If the entity has established such a process (referred to hereafter as the "entity's risk assessment process"), the auditor shall obtain an understanding of it, and the results thereof. If the auditor identifies risks of material misstatement that management failed to identify, the auditor shall evaluate whether there was an underlying risk of a kind that the auditor expects would have been identified by the entity's risk assessment process. If there is such a risk, the auditor shall obtain an understanding of why that process failed to identify it, and evaluate whether the process is appropriate to its circumstances or determine if there is a significant deficiency in internal control with regard to the entity's risk assessment process.	**12.26** 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. **12.27** 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.
315.17 If the entity has not established such a process or has an ad hoc process, the auditor shall discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor shall evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances, or determine whether it represents a significant deficiency in internal control. (Ref: Para. A80)	-
315.A5 Although the auditor is required to perform all the risk assessment procedures described in paragraph 6 in the course of obtaining the required understanding of the entity (see paragraphs 11–24), the auditor is not required to perform all of them for each aspect of that understanding. Other procedures may be performed where the information to be obtained therefrom may be helpful in identifying risks of material misstatement. Examples of such procedures include: • Reviewing information obtained from external sources such as trade and economic journals; reports by analysts, banks, or rating agencies; or regulatory or financial publications. • Making inquiries of the entity's external legal counsel or of valuation experts that the entity has used. **315.A24**	**12.11** As part of obtaining an understanding of the company as required by paragraph 7, the auditor should consider performing the following procedures and the extent to which the procedures should be performed: • Reading public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and, in an integrated audit, the effectiveness of the company's internal control over financial reporting, e.g., company issued press releases, company-prepared presentation materials for analysts or investor groups, and analyst reports; • Observing or reading transcripts of earnings calls and, to the extent publicly available, other meetings with investors or rating agencies; Obtaining an understanding of compensation arrangements with senior management, including

ISA	AS (AU)
Examples of matters that the auditor may consider when obtaining an understanding of the nature of the entity include: • Business operations such as: ○ Nature of revenue sources, products or services, and markets, including involvement in electronic commerce such as Internet sales and marketing activities. ○ Conduct of operations (for example, stages and methods of production, or activities exposed to environmental risks). ○ Alliances, joint ventures, and outsourcing activities. ○ Geographic dispersion and industry segmentation. ○ Location of production facilities, warehouses, and offices, and location and quantities of inventories. ○ Key customers and important suppliers of goods and services, employment arrangements (including the existence of union contracts, pension and other postemployment benefits, stock option or incentive bonus arrangements, and government regulation related to employment matters). ○ Research and development activities and expenditures. ○ Transactions with related parties. • Investments and investment activities such as: ○ Planned or recently executed acquisitions or divestitures. ○ Investments and dispositions of securities and loans. ○ Capital investment activities. ○ Investments in non-consolidated entities, including partnerships, joint ventures and special-purpose entities. • Financing and financing activities such as: ○ Major subsidiaries and associated entities, including consolidated and non-consolidated structures. ○ Debt structure and related terms, including off-balance-sheet financing arrangements and leasing arrangements. ○ Beneficial owners (local, foreign, business reputation and experience) and related parties. ○ Use of derivative financial instruments. • Financial reporting such as: ○ Accounting principles and industry-specific practices, including industry-specific significant categories (for example, loans and investments for banks, or research and development for pharmaceuticals). ○ Revenue recognition practices. ○ Accounting for fair values. ○ Foreign currency assets, liabilities and transactions. ○ Accounting for unusual or complex transactions including those in controversial or emerging areas (for example, accounting for stock-based compensation).	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).
315.18(b) The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas: (b) The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements; **315.A54** The use of manual or automated elements in internal control also affects the manner in which transactions are initiated, recorded, processed, and reported: • Controls in a manual system may include such procedures as approvals and reviews of transactions, and reconciliations and follow-up of reconciling items. Alternatively, an entity may use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format replace paper documents. • Controls in IT systems consist of a combination of automated controls (for example, controls embedded in computer programs) and manual controls. Further, manual controls may be independent of IT, may use information produced by IT, or may be limited to monitoring the effective functioning of IT and of automated controls, and to handling exceptions. When IT is used to initiate, record, process or report transactions, or other financial data for inclusion in financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or may be critical to the effective functioning of manual controls that depend on IT. An entity's mix of manual and automated elements in internal control varies with the nature and complexity of	**12.29** 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.

ISA	AS (AU)
the entity's use of IT.	
RISKS OF MATERIAL MISSTATEMENTS **Risk Assessment: Understanding Internal Control**	
315.29 If the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity's controls, including control activities, relevant to that risk. (Ref: Para. A124–A126)	**12.72** 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. **12.20** 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.
315.12 The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. (Ref: Para. A42–A65) **315.A5** (see above)	**12.18** The auditor should obtain a sufficient understanding of each component of internal control over financial reporting ("understanding of internal control") to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures. **12.20** (see above)
315.20 The auditor shall obtain an understanding of control activities relevant to the audit, being those the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. (Ref: Para. A88–A94) **315.21** In understanding the entity's control activities, the auditor shall obtain an understanding of how the entity has responded to risks arising from IT. (Ref: Para. A95–A97) **315.A92** The auditor's knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control assists the auditor in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities.	**12.34** 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. 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.
315.14 The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether: (a) Management, with the oversight of those charged	**12.24** 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

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with governance, has created and maintained a culture of honesty and ethical behavior; and (b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment. (Ref: Para. A69–A78) **315.A70** Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following: (a) *Communication and enforcement of integrity and ethical values* – These are essential elements that influence the effectiveness of the design, administration and monitoring of controls. (b) *Commitment to competence* – Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge. (c) *Participation by those charged with governance* – Attributes of those charged with governance such as: • Their independence from management. • Their experience and stature. • The extent of their involvement and the information they receive, and the scrutiny of activities. • The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors. (d) *Management's philosophy and operating style* – Characteristics such as management's: • Approach to taking and managing business risks. • Attitudes and actions toward financial reporting. • Attitudes toward information processing and accounting functions and personnel. (e) *Organizational structure* – The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed. (f) *Assignment of authority and responsibility* – Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established. (g) *Human resource policies and practices* – Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.	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, Auditing Standard No. 514/ describes the auditor's responsibility for evaluating the control environment.
315.A42 An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement, and in designing the nature, timing and extent of further audit procedures.	**12.39** 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 or for the purpose of expressing an opinion on internal control over financial reporting in the audit of internal control over financial reporting. 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. **12.40** *Relationship of Understanding of Internal Control to Evaluating Entity- Level Controls in an Audit of Internal Control Over Financial Reporting.* Auditing Standard No. 5 states, "The auditor must test those entity-level controls that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting." 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. The auditor should take into account the evidence obtained from understanding internal control when determining the nature, timing, and extent of procedures necessary to

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	support the auditor's conclusions about the effectiveness of entity-level controls in the audit of internal control over financial reporting.
RISKS OF MATERIAL MISSTATEMENTS **Risk Assessment: Identification of Risks**	
315.3 The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.	**12.3** The objective of the auditor is to identify and appropriately assess the risks of material misstatement, thereby providing a basis for designing and implementing responses to the risks of material misstatement. **12.4** The auditor should perform risk assessment procedures that are sufficient to provide a reasonable basis for identifying and assessing the risks of material misstatement, whether due to error or fraud, and designing further audit procedures.
240.A22 In addition to information obtained from applying analytical procedures, other information obtained about the entity and its environment may be helpful in identifying the risks of material misstatement due to fraud. The discussion among team members may provide information that is helpful in identifying such risks. In addition, information obtained from the auditor's client acceptance and retention processes, and experience gained on other engagements performed for the entity, for example, engagements to review interim financial information, may be relevant in the identification of the risks of material misstatement due to fraud.	**12.44** *Other Engagements.* When the auditor has performed a review of interim financial information in accordance with AU sec. 722, *Interim Financial Information,* the auditor should evaluate whether information obtained during the review is relevant to identifying risks of material misstatement in the year-end audit.
315.8 If the engagement partner has performed other engagements for the entity, the engagement partner shall consider whether information obtained is relevant to identifying risks of material misstatement.	**12.45** 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 firm25/ and should take into account relevant information obtained from those engagements in identifying risks of material misstatement.
	12.60 To identify significant accounts and disclosures and their relevant assertions in accordance with paragraph 59.e., the auditor should evaluate the qualitative and quantitative risk factors related to the financial statement line items and disclosures. Risk factors relevant to the identification of significant accounts and disclosures and their relevant assertions include: • Size and composition of the account; • Susceptibility to misstatement due to error or fraud; Volume of activity, complexity, and homogeneity of the individual transactions processed through the account or reflected in the disclosure; • Nature of the account or disclosure; • 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. **12.61** 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. **12.62** 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

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	significant accounts and disclosures and relevant assertions.
315.7 The auditor shall consider whether information obtained from the auditor's client acceptance or continuance process is relevant to identifying risks of material misstatement.	**12.41** *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.
315.9 (see above)	**12.42** *Past Audits.* In subsequent years, the auditor should incorporate knowledge obtained during past audits into the auditor's process for identifying risks of material misstatement, including when identifying significant ongoing matters that affect the risks of material misstatement or determining how changes in the company or its environment affect the risks of material misstatement, as discussed in paragraph 8 of this standard. **12.43** 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.
315.A105 Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level, for example, through management override of internal control. Financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud. **315.A109** Risks of material misstatement at the assertion level for classes of transactions, account balances, and disclosures need to be considered because such consideration directly assists in determining the nature, timing and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence. In identifying and assessing risks of material misstatement at the assertion level, the auditor may conclude that the identified risks relate more pervasively to the financial statements as a whole and potentially affect many assertions.	**12.59.c** 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: 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.
RISKS OF MATERIAL MISSTATEMENTS **Risk Assessment: Significant Risks**	
315.4 (e) Significant risk – An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.	**12.70** 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. **12.A5** Significant risk – A risk of material misstatement that requires special audit consideration.
315.27 As part of the risk assessment as described in paragraph 25, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk.	**12.59.f** Determine whether any of the identified and assessed risks of material misstatement are **significant risks** (paragraphs 70-71 of this standard).
315.28 In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following: (a)	**12.71** Factors that should be evaluated in determining which risks are significant risks include: a. The effect of the

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Whether the risk is a risk of fraud; (b) Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention; (c) The complexity of transactions; (d) Whether the risk involves significant transactions with related parties; (e) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and (f) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual. (Ref: Para. A119–A123)	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.
RISKS OF MATERIAL MISSTATEMENTS **Analytical Procedures**	
315.5 The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. **315.4 (d)** Risk assessment procedures – The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels. **315.25** The auditor shall identify and assess the risks of material misstatement at: (a) the financial statement level; and (Ref: Para. A105–A108) (b) the assertion level for classes of transactions, account balances, and disclosures, (Ref: Para. A109–A113) to provide a basis for designing and performing further audit procedures.	**12.4** The auditor should perform risk assessment procedures that are sufficient to provide a reasonable basis for identifying and assessing the risks of material misstatement, whether due to error or fraud, and designing further audit procedures. **12.59** The auditor should identify and assess the risks of material misstatement at the financial statement level and the assertion level. In identifying and assessing risks of material misstatement, the auditor should: a. Identify risks of misstatement using information obtained from performing risk assessment procedures (as discussed in paragraphs 4-58) and considering the characteristics of the accounts and disclosures in the financial statements. Note: Factors relevant to identifying fraud risks are discussed in paragraphs 65-69 of this standard. b. Evaluate whether the identified risks relate pervasively to the financial statements as a whole and potentially affect many assertions. c. Evaluate the types of potential misstatements that could result from the identified risks and the accounts, disclosures, and assertions that could be affected. Note: In identifying and assessing risks at the assertion level, the auditor should evaluate how risks at the financial statement level could affect risks of misstatement at the assertion level. d. Assess the likelihood of misstatement, including the possibility of multiple misstatements, and the magnitude of potential misstatement to assess the possibility that the risk could result in material misstatement of the financial statements. Note: In assessing the likelihood and magnitude of potential misstatement, the auditor may take into account the planned degree of reliance on controls selected to test. e. Identify significant accounts and disclosures and their relevant assertions (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).
315.6 The risk assessment procedures shall include the following: (a) Inquiries of management, and of others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error. (Ref: Para. A6) (b) Analytical procedures. (Ref: Para. A7–A10) (c) Observation and inspection. (Ref: Para. A11) **315.11** The auditor shall obtain an understanding of the following: (a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework. (Ref: Para. A17–A22) (b) The nature of the entity, including: (i) its operations; (ii) its ownership and governance structures; (iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and (iv)	**12.5** Risks of material misstatement can arise from a variety of sources, including external factors, such as conditions in the company's industry and environment, and company-specific factors, such as the nature of the company, its activities, and internal control over financial reporting. For example, external or company-specific factors can affect the judgments involved in determining accounting estimates or create pressures to manipulate the financial statements to achieve certain financial targets. Also, risks of material misstatement may relate to, e.g., personnel who lack the necessary financial reporting competencies, information systems that fail to accurately capture business transactions, or financial reporting processes that are not adequately aligned with the requirements in the applicable financial reporting framework. Thus, the audit procedures that are

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the way that the entity is structured and how it is financed, to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements. (Ref: Para. A23–A27) (c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry. (Ref: Para. A28) (d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement. (Ref: Para. A29–A35) (e) The measurement and review of the entity's financial performance. (Ref: Para. A36–A41) **315.A17** A17. Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments. Examples of matters the auditor may consider include: • The market and competition, including demand, capacity, and price competition. • Cyclical or seasonal activity. • Product technology relating to the entity's products. • Energy supply and cost.	necessary to identify and appropriately assess the risks of material misstatement include consideration of both external factors and company-specific factors. This standard discusses the following risk assessment procedures: a. Obtaining an understanding of the company and its environment (paragraphs 7-17); b. Obtaining an understanding of internal control over financial reporting (paragraphs 18-40); c. Considering information from the client acceptance and retention evaluation, audit planning activities, past audits, and other engagements performed for the company (paragraphs 41-45); d. Performing analytical procedures (paragraphs 46-48); e. Conducting a discussion among engagement team members regarding the risks of material misstatement (paragraphs 49-53); and f. Inquiring of the audit committee, management, and others within the company about the risks of material misstatement (paragraphs 54-58). 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.
240.22 The auditor shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud. **315.A7** Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.	**14.7** The nature and extent of the analytical procedures performed during the overall review may be similar to the analytical procedures performed as risk assessment procedures. The auditor should perform analytical procedures relating to revenue through the end of the reporting period.
315.A8 Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.	-
330.21 If the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details. (Ref: Para. A53)	**13.11** For significant risks, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed risks. Note: Auditing Standard No. 12 discusses identification of significant risks10/ and states that fraud risks are significant risks.
240.31 Management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk. **240.32** Irrespective of the auditor's assessment of the risks of management override of controls, the auditor shall design and perform audit procedures to: (a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. In designing and performing audit procedures for such tests, the auditor	**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. 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,

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shall: (i) Make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments; (ii) Select journal entries and other adjustments made at the end of a reporting period; and (iii) Consider the need to test journal entries and other adjustments throughout the period. (Ref: Para. A41–A44) (b) Review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. In performing this review, the auditor shall: (i) Evaluate whether the judgments and decisions made by management in making the accounting estimates included in the financial statements, even if they are individually reasonable, indicate a possible bias on the part of the entity's management that may represent a risk of material misstatement due to fraud. If so, the auditor shall reevaluate the accounting estimates taken as a whole; and (ii) Perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year. (Ref: Para. A45– A47) (c) For 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 and other information obtained during the audit, the auditor shall evaluate whether the business rationale (or the lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. (Ref: Para. A48) **240.33** The auditor shall determine whether, in order to respond to the identified risks of management override of controls, the auditor needs to perform other audit procedures in addition to those specifically referred to above (that is, where there are specific additional risks of management override that are not covered as part of the procedures performed to address the requirements in paragraph 32).	causing the auditor to draw erroneous conclusions. For this reason, substantive analytical procedures alone are not well suited to detecting fraud.
520.A13 The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor generally has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over non-financial information may often be tested in conjunction with other tests of controls. For example, in establishing controls over the processing of sales invoices, an entity may include controls over the recording of unit sales. In these circumstances, the auditor may test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing of sales invoices. Alternatively, the auditor may consider whether the information was subjected to audit testing. ISA 500 establishes requirements and provides guidance in determining the audit procedures to be performed on the information to be used for substantive analytical procedures. **330.8** The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls if: (a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or (b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level. (Ref: Para. A20–A24)	**329.16** 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
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	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.
330.A15 The extent of an audit procedure judged necessary is determined after considering the materiality, the assessed risk, and the degree of assurance the auditor plans to obtain. When a single purpose is met by a combination of procedures, the extent of each procedure is considered separately. In general, the extent of audit procedures increases as the risk of material misstatement increases. For example, in response to the assessed risk of material misstatement due to fraud, increasing sample sizes or performing substantive analytical procedures at a more detailed level may be appropriate. However, increasing the extent of an audit procedure is effective only if the audit procedure itself is relevant to the specific risk. **330.A19** When obtaining more persuasive audit evidence because of a higher assessment of risk, the auditor may increase the quantity of the evidence, or obtain evidence that is more relevant or reliable, for example, by placing more emphasis on obtaining third party evidence or by obtaining corroborating evidence from a number of independent sources.	**8.11** 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.
330.18 Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure. (Ref: Para. A42–A47)	**13.36** The auditor should perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk.
200.17 To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion. (Ref: Para. A28–A52)	**8.3** To form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud. Reasonable assurance is obtained by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence.
CONSIDERATION OF MATERIAL MISSTATEMENTS **Materiality**	
320.10 When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures. (Ref: Para. A2– A11)	**11.6** To plan the nature, timing, and extent of audit procedures, the auditor should establish a materiality level for the financial statements as a whole that is appropriate in light of the particular circumstances. This includes consideration of the company's earnings and other relevant factors. To determine the nature, timing, and extent of audit procedures, the materiality level for the financial statements as a whole needs to be expressed as a specified amount. Note: If financial statements for the audit period are not available, the auditor may establish an initial materiality level based on estimated or preliminary financial statement amounts. In those situations, the auditor should take into account the effects of known or expected changes in the company's financial statements, including significant transactions or adjustments that are expected to be reflected in the financial statements at the end of the period.
320.11 The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures. (Ref: Para. A12) **320.A12** Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and leaves no margin for possible undetected misstatements.	**11.8** The auditor should determine the amount or amounts of tolerable misstatement for purposes of assessing risks of material misstatement and planning and performing audit procedures at the account or disclosure level. The auditor should determine tolerable misstatement at an amount or amounts that reduce to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the financial statements. Accordingly, tolerable misstatement should be less than the

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Performance materiality (which, as defined, is one or more amounts) is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole. Similarly, performance materiality relating to a materiality level determined for a particular class of transactions, account balance or disclosure is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in that particular class of transactions, account balance or disclosure exceeds the materiality level for that particular class of transactions, account balance or disclosure. The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period.	materiality level for the financial statements as a whole and, if applicable, the materiality level or levels for particular accounts or disclosures. **11.9** In determining tolerable misstatement and planning and performing audit procedures, the auditor should take into account the nature, cause (if known), and amount of misstatements that were accumulated in audits of the financial statements of prior periods.
320.12 The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially. (Ref: Para. A13) **320.A13** Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures. For example, if during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period-end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality.	**11.11** 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.
CONSIDERATION OF MATERIAL MISSTATEMENTS **Audit Planning and Performing: Audit Strategy and Audit Plan**	
300.9 The auditor shall develop an audit plan that shall include a description of: (a) The nature, timing and extent of planned risk assessment procedures, as determined under ISA 315.4 (b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under ISA 330. (c) Other planned audit procedures that are required to be carried out so that the engagement complies with ISAs. (Ref: Para. A12)	**9.4** The auditor should properly plan the audit. This standard describes the auditor's responsibilities for properly planning the audit. 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.
300.9 (see above)	**9.10** 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; b. The planned nature, timing, and extent of tests of controls and substantive procedures; and c. Other planned audit procedures required to be performed so that the engagement complies with PCAOB standards.
300.12 The auditor shall include in the audit documentation:(a) The overall audit strategy; (b) The audit plan; and (c) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes. (Ref: Para. A16–A19)	**9.10** (See above)

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CONSIDERATION OF MATERIAL MISSTATEMENTS **Audit Planning and Performing: Audit Supervision**	
220.15 The engagement partner shall take responsibility for: (a) The direction, supervision and performance of the audit engagement in compliance with professional standards and applicable legal and regulatory requirements; and (Ref: Para. A13–A15, A20) (b) The auditor's report being appropriate in the circumstances. **220.A13** Direction of the engagement team involves informing the members of the engagement team of matters such as: • Their responsibilities, including the need to comply with relevant ethical requirements, and to plan and perform an audit with professional skepticism as required by ISA 200.6 • Responsibilities of respective partners where more than one partner is involved in the conduct of an audit engagement. • The objectives of the work to be performed. • The nature of the entity's business. • Risk-related issues. • Problems that may arise. • The detailed approach to the performance of the engagement. Discussion among members of the engagement team allows less experienced team members to raise questions with more experienced team members so that appropriate communication can occur within the engagement team. **220.A14** Appropriate teamwork and training assist less experienced members of the engagement team to clearly understand the objectives of the assigned work. **220.A15** Supervision includes matters such as: • Tracking the progress of the audit engagement. • Considering the competence and capabilities of individual members of the engagement team, including whether they have sufficient time to carry out their work, whether they understand their instructions and whether the work is being carried out in accordance with the planned approach to the audit engagement. • Addressing significant matters arising during the audit engagement, considering their significance and modifying the planned approach appropriately. • Identifying matters for consultation or consideration by more experienced engagement team members during the audit engagement.	**10.5** The engagement partner and, as applicable, other engagement team members performing supervisory activities, should: a. Inform engagement team members of their responsibilities, 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, 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; Note: In applying due professional care in accordance with AU sec. 230, each engagement team member has a responsibility to bring to the attention of appropriate persons, disagreements or concerns the engagement team member might have with respect to accounting and auditing issues that he or she believes are of significance to the financial statements or the auditor's report regardless of how those disagreements or concerns may have arisen. c. Review the work of engagement team members to evaluate whether: (1) The work was performed and documented; (2) The objectives of the procedures were achieved; and (3) The results of the work support the conclusions reached.
220.16 The engagement partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures. (Ref: Para. A16–A17, A20) **220.A16** Under ISQC 1, the firm's review responsibility policies and procedures are determined on the basis that work of less experienced team members is reviewed by more experienced team members.	**10.4** The engagement partner may seek assistance from appropriate engagement team members in fulfilling his or her responsibilities pursuant to this standard. Engagement team members who assist the engagement partner with supervision of the work of other engagement team members also should comply with the requirements in this standard with respect to the supervisory responsibilities assigned to them.
220.A16 (see above) **220.A17** A review consists of consideration whether, for example: • The work has been performed in accordance with professional standards and applicable legal and regulatory requirements; • Significant matters have been raised for further consideration; • Appropriate consultations have taken place and the resulting conclusions have been documented and implemented; • There is a need to revise the nature, timing and extent of work performed; • The work performed supports the conclusions reached and is appropriately documented; • The evidence obtained is sufficient and appropriate to support the auditor's report; and • The objectives of the engagement procedures have been achieved.	**10.5** (see above)
300.11 The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. (Ref: Para. A14– A15) **300.A14**	**10.6** To determine the extent of supervision necessary for engagement team members to perform their work as directed and form appropriate conclusions, the engagement partner and other engagement team

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The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors, including: • The size and complexity of the entity. • The area of the audit. • The assessed risks of material misstatement (for example, an increase in the assessed risk of material misstatement for a given area of the audit ordinarily requires a corresponding increase in the extent and timeliness of direction and supervision of engagement team members, and a more detailed review of their work). • The capabilities and competence of the individual team members performing the audit work. ISA 220 contains further guidance on the direction, supervision and review of audit work.	members performing supervisory activities should take into account: a. The nature of the company, including its size and complexity; 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. Note: In accordance with the requirements of paragraph 5 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, the extent of supervision of engagement team members should be commensurate with the risks of material misstatement.
220.22 If differences of opinion arise within the engagement team, with those consulted or, where applicable, between the engagement partner and the engagement quality control reviewer, the engagement team shall follow the firm's policies and procedures for dealing with and resolving differences of opinion.	**10.5** (see above) **3.12** 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. 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. 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. 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.
CONSIDERATION OF MATERIAL MISSTATEMENTS **Auditor's Responses to Risks of Material Misstatements: Overall Responses to Risks**	
330.3 The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.	**13.2** The objective of the auditor is to address the risks of material misstatement through appropriate overall audit responses and audit procedures.
330.5 The auditor shall design and implement overall responses to address the assessed risks of material misstatement at the financial statement level. (Ref: Para. A1–A3) **330.6** The auditor shall design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level. (Ref: Para. A4–A8)	**13.5** The auditor should design and implement overall responses to address the assessed risks of material misstatement as follows: a. *Making appropriate assignments of significant engagement responsibilities.* The knowledge, skill, and ability of engagement team members with significant engagement responsibilities should be commensurate with the assessed risks of material misstatement. b. *Providing the extent of supervision that is appropriate for the circumstances, including, in particular, the assessed risks of material misstatement.* (See paragraphs 5–6 of Auditing Standard No. 10, *Supervision of the Audit Engagement*.) c. *Incorporating elements of unpredictability in the selection of audit procedures to be performed.* As part of the

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	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.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, are indicative of bias that could lead to material misstatement of the financial statements. Note: Paragraph .11 of AU sec. 380, *Communication With Audit Committees,* discusses the auditor's judgments about the quality of a company's accounting principles.
330.A1 Overall responses to address the assessed risks of material misstatement at the financial statement level may include:• Emphasizing to the audit team the need to maintain professional skepticism. • Assigning more experienced staff or those with special skills or using experts. • Providing more supervision. • Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed. • Making general changes to the nature, timing or extent of audit procedures, for example: performing substantive procedures at the period end instead of at an interim date; or modifying the nature of audit procedures to obtain more persuasive audit evidence. **330.A2** The assessment of the risks of material misstatement at the financial statement level, and thereby the auditor's overall responses, is affected by the auditor's understanding of the control environment. An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and thus, for example, allow the auditor to conduct some audit procedures at an interim date rather than at the period end. Deficiencies in the control environment, however, have the opposite effect; for example, the auditor may respond to an ineffective control environment by: • Conducting more audit procedures as of the period end rather than at an interim date. • Obtaining more extensive audit evidence from substantive procedures. • Increasing the number of locations to be included in the audit scope. **330.A3** Such considerations, therefore, have a significant bearing on the auditor's general approach, for example, an emphasis on substantive procedures (substantive approach), or an approach that uses tests of controls as well as substantive procedures (combined approach). **330.A4** The auditor's assessment of the identified risks at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. For example, the auditor may determine that: (a) Only by performing tests of controls may the auditor achieve an effective response to the assessed risk of material misstatement for a particular assertion; (b) Performing only substantive procedures is appropriate for particular assertions and, therefore, the	**13.5** (see above) **13.6** The auditor also should determine whether it is necessary to make pervasive changes to the nature, timing, or extent of audit procedures to adequately address the assessed risks of material misstatement. Examples of such pervasive changes include modifying the audit strategy to: a. Increase the substantive testing of the valuation of numerous significant accounts at year end because of significantly deteriorating market conditions, and b. Obtain more persuasive audit evidence from substantive procedures due to the identification of pervasive weaknesses in the company's control environment. **13.7** 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 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.

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auditor excludes the effect of controls from the relevant risk assessment. This may be because the auditor's risk assessment procedures have not identified any effective controls relevant to the assertion, or because testing controls would be inefficient and therefore the auditor does not intend to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures; or (c) A combined approach using both tests of controls and substantive procedures is an effective approach. However, as required by paragraph 18, irrespective of the approach selected, the auditor designs and performs substantive procedures for each material class of transactions, account balance, and disclosure. **330.A5** The nature of an audit procedure refers to its purpose (that is, test of controls or substantive procedure) and its type (that is, inspection, observation, inquiry, confirmation, recalculation, reperformance, or analytical procedure). The nature of the audit procedures is of most importance in responding to the assessed risks. 330.A6. Timing of an audit procedure refers to when it is performed, or the period or date to which the audit evidence applies. **330.A7** Extent of an audit procedure refers to the quantity to be performed, for example, a sample size or the number of observations of a control activity. **330.A8** Designing and performing further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level provides a clear linkage.	
330.A1 Overall responses to address the assessed risks of material misstatement at the financial statement level may include: • Emphasizing to the audit team the need to maintain professional skepticism. • Assigning more experienced staff or those with special skills or using experts. • Providing more supervision. • Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed. • Making general changes to the nature, timing or extent of audit procedures, for example: performing substantive procedures at the period end instead of at an interim date; or modifying the nature of audit procedures to obtain more persuasive audit evidence.	**13.6** (see above)
330.19 The auditor shall consider whether external confirmation procedures are to be performed as substantive audit procedures. (Ref: Para. A48–A51) **330.A48-.A53 330.A7-.A51**	**13.36** The auditor should perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk.
CONSIDERATION OF MATERIAL MISSTATEMENTS **Auditor's Responses to Risks of Material Misstatements: Tests of Controls**	
-	**13.9.c** In designing the audit procedures to be performed, the auditor should: 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 assessments for purposes of the audit of financial statements; and (2) To obtain sufficient evidence to support the auditor's opinion on internal control over financial reporting as of year-end. Note: Auditing Standard No. 5 establishes requirements for tests of controls in the audit of internal control over financial reporting.
330.9 In designing and performing tests of controls, the auditor shall obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control. (Ref: Para. A25) **330.A25** A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls, in	**13.18** *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

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particular where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.	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.
330.10 In designing and performing tests of controls, the auditor shall: (a) Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including: (i) How the controls were applied at relevant times during the period under audit; (ii) The consistency with which they were applied; and (iii) By whom or by what means they were applied. (Ref: Para. A26– A29) (b) Determine whether the controls to be tested depend upon other controls (indirect controls), and, if so, whether it is necessary to obtain audit evidence supporting the effective operation of those indirect controls. (Ref: Para. A30–A31) **330.A27** The nature of the particular control influences the type of procedure required to obtain audit evidence about whether the control was operating effectively. For example, if operating effectiveness is evidenced by documentation, the auditor may decide to inspect it to obtain audit evidence about operating effectiveness. For other controls, however, documentation may not be available or relevant. For example, documentation of operation may not exist for some factors in the control environment, such as assignment of authority and responsibility, or for some types of control activities, such as control activities performed by a computer. In such circumstances, audit evidence about operating effectiveness may be obtained through inquiry in combination with other audit procedures such as observation or the use of CAATs.	**13.19** 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.
330.13 In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following: (a) The effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process; (b) The risks arising from the characteristics of the control, including whether it is manual or automated; (c) The effectiveness of general IT controls; (d) The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affect the application of the control; (e) Whether the lack of a change in a particular control poses a risk due to changing circumstances; and (f) The risks of material misstatement and the extent of reliance on the control. (Ref: Para. A35)	**13.31** *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); • 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

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	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.
330.14 If the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, the auditor shall establish the continuing relevance of that evidence by obtaining audit evidence about whether significant changes in those controls have occurred subsequent to the previous audit. The auditor shall obtain this evidence by performing inquiry combined with observation or inspection, to confirm the understanding of those specific controls, and: (a) If there have been changes that affect the continuing relevance of the audit evidence from the previous audit, the auditor shall test the controls in the current audit. (Ref: Para. A36) (b) If there have not been such changes, the auditor shall test the controls at least once in every third audit, and shall test some controls each audit to avoid the possibility of testing all the controls on which the auditor intends to rely in a single audit period with no testing of controls in the subsequent two audit periods. (Ref: Para. A37–A39) **330.13** (see above)	-
330.16 When evaluating the operating effectiveness of relevant controls, the auditor shall evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively. The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the assertion being tested are effective. (Ref: Para. A40) **330.17** If deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences, and shall determine whether: (Ref: Para. A41) (a) The tests of controls that have been performed provide an appropriate basis for reliance on the controls; (b) Additional tests of controls are necessary; or (c) The potential risks of misstatement need to be addressed using substantive procedures. **330.A40** A material misstatement detected by the auditor's procedures is a strong indicator of the existence of a significant deficiency in internal control.	**13.32** 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. **13.33** 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. **13.34** When deficiencies affecting the controls on which the auditor intends to rely are detected, the auditor should evaluate the severity of the deficiencies and the effect on the auditor's control risk assessments. If the auditor plans to rely on controls relating to an assertion but the controls that the auditor tests are ineffective because of control deficiencies, the auditor should: a. Perform tests of other controls related to the same assertion as the ineffective controls, or b. Revise the control risk assessment and modify the planned substantive procedures as necessary in light of the increased assessment of risk. Note: Auditing Standard No. 5 establishes requirements for evaluating the severity of a control deficiency and communicating identified control deficiencies to management and the audit committee in an integrated audit. AU sec. 325, *Communications About Control Deficiencies in an Audit of Financial Statements,* establishes requirements for communicating significant deficiencies and material weaknesses in an audit of financial statements only.
CONSIDERATION OF MATERIAL MISSTATEMENTS **Auditor's Responses to Risks of Material Misstatements: Interim Substantive Procedures**	
330.A56 Performing substantive procedures at an interim date without undertaking additional procedures at a later date increases the risk that the auditor will not detect misstatements that may exist at the period end. This risk increases as the remaining period is lengthened. Factors such as the following may influence whether to perform substantive procedures at an interim date: • The control environment and other relevant controls. • The availability at a later date of information necessary for the auditor's procedures. • The purpose of the substantive procedure. • The assessed risk of material misstatement. • The nature of the class of transactions or account	**13.44** 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

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balance and related assertions. • The ability of the auditor to perform appropriate substantive procedures or substantive procedures combined with tests of controls to cover the remaining period in order to reduce the risk that misstatements that may exist at the period end will not be detected.	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.
330.22 If substantive procedures are performed at an interim date, the auditor shall cover the remaining period by performing: (a) substantive procedures, combined with tests of controls for the intervening period; or (b) if the auditor determines that it is sufficient, further substantive procedures only, that provide a reasonable basis for extending the audit conclusions from the interim date to the period end. (Ref: Para. A54–A57) **330.A55** In some circumstances, the auditor may determine that it is effective to perform substantive procedures at an interim date, and to compare and reconcile information concerning the balance at the period end with the comparable information at the interim date to: (a) Identify amounts that appear unusual; (b) Investigate any such amounts; and (c) Perform substantive analytical procedures or tests of details to test the intervening period.	**13.45** 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.
330.A23 In addition, the auditor may design a test of controls to be performed concurrently with a test of details on the same transaction. Although the purpose of a test of controls is different from the purpose of a test of details, both may be accomplished concurrently by performing a test of controls and a test of details on the same transaction, also known as a dual-purpose test. For example, the auditor may design, and evaluate the results of, a test to examine an invoice to determine whether it has been approved and to provide substantive audit evidence of a transaction. A dual-purpose test is designed and evaluated by considering each purpose of the test separately.	**13.47** 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 dualpurpose 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.
200.A48 The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive. Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. Notwithstanding this, the relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost. This is recognized in certain financial reporting frameworks (see, for example, the IASB's "Framework for the Preparation and Presentation of Financial Statements"). Therefore, there is an expectation by users of financial statements that the auditor will form an opinion on the financial statements within a reasonable period of time and at a reasonable cost, recognizing that it is impracticable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is in error or fraudulent until proved otherwise.	-
CONSIDERATION OF MATERIAL MISSTATEMENTS **Auditor's Responses to Risks of Material Misstatements: Evaluation of Audit Results**	
520.6 The auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity. (Ref: Para. A17–A19)	**14.5** In the overall review, the auditor should read the financial statements and disclosures and perform analytical procedures to (a) evaluate the auditor's conclusions formed regarding significant accounts and disclosures and (b) assist in forming an opinion on whether the financial statements as a whole are free of material misstatement.
500.A23 Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from	**14.8** The auditor should obtain corroboration for management's explanations regarding significant unusual or unexpected transactions, events, amounts, or relationships. If management's responses to the auditor's

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other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures. **520.A21** The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.	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.
450.8 The auditor shall communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation. The auditor shall request management to correct those misstatements. (Ref: Para. A7–A9) **450.7** If, at the auditor's request, management has examined a class of transactions, account balance or disclosure and corrected misstatements that were detected, the auditor shall perform additional audit procedures to determine whether misstatements remain. (Ref: Para. A6)	**14.15** The auditor should communicate accumulated misstatements to management on a timely basis to provide management with an opportunity to correct them. **14.16** 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. **14.17** *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. (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." 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 …." 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 that it could lead to a material contingent liability or a material loss of revenue. Also, a misstatement made intentionally could be material for qualitative reasons, even if relatively small in amount. Note: If the reevaluation of the established materiality level or levels, as set forth in Auditing Standard No. 11, 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.
330.A611 The auditor cannot assume that an instance of fraud or error is an isolated occurrence. Therefore, the consideration of how the detection of a misstatement affects the assessed risks of material misstatement is important in determining whether the assessment remains appropriate.	**14.19** 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.
CONSIDERATION OF MATERIAL MISSTATEMENTS **Audit Sampling**	
500.10 When designing tests of controls and tests of details, the auditor shall determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure. (Ref: Para. A52–A56)	**15.22** 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

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	items for testing are: • Selecting all items; • Selecting specific items; and • Audit sampling.
530.13 In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly, the auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population. The auditor shall obtain this degree of certainty by performing additional audit procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population.	**AU 350.24** 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.
MATERIAL MISSTATEMENTS DUE TO FRAUD **Auditor's Responsibilities Regarding Fraud: Responsibility for the Prevention and Detection of Fraud**	
240.12 In accordance with ISA 2005, the auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance. (Ref: Para. A7–A8) **240.A7** Maintaining professional skepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist. It includes considering the reliability of the information to be used as audit evidence and the controls over its preparation and maintenance where relevant. Due to the characteristics of fraud, the auditor's professional skepticism is particularly important when considering the risks of material misstatement due to fraud. **200.13** For purposes of the ISAs, the following terms have the meanings attributed below: (l) Professional skepticism – An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.	**13.7** 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 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. 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. **316.13** 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 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. **230.8** 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.]
240.13 Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further. (Ref: Para. A9) **240.A9** An audit performed in accordance with ISAs rarely involves the authentication of documents, nor is the	**15.9** The auditor is not expected to be an expert in document authentication. However, if conditions indicate that a document may not be authentic or that the terms in a document have been modified but that the modifications have not been disclosed to the auditor, the auditor should modify the planned audit procedures or perform additional audit procedures to respond to those conditions and should evaluate the effect, if any, on the other aspects of the audit. **316.9**

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auditor trained as or expected to be an expert in such authentication. However, when the auditor identifies conditions that cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, possible procedures to investigate further may include: • Confirming directly with the third party. • Using the work of an expert to assess the document's authenticity. **200.A21** The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence. In cases of doubt about the reliability of information or indications of possible fraud (for example, if conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document may have been falsified), the ISAs require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter.	Typically, management and employees engaged in fraud will take steps to conceal the fraud from the auditors and others within and outside the organization. Fraud may be concealed by withholding evidence or misrepresenting information in response to inquiries or by falsifying documentation. For example, management that engages in fraudulent financial reporting might alter shipping documents. Employees or members of management who misappropriate cash might try to conceal their thefts by forging signatures or falsifying electronic approvals on disbursement authorizations. An audit conducted in accordance with GAAS rarely involves the authentication of such documentation, nor are auditors trained as or expected to be experts in such authentication. In addition, an auditor may not discover the existence of a modification of documentation through a side agreement that management or a third party has not disclosed. **316.12** 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. 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.
240.32 Irrespective of the auditor's assessment of the risks of management override of controls, the auditor shall design and perform audit procedures to: (a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. In designing and performing audit procedures for such tests, the auditor shall: (i) Make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments; (ii) Select journal entries and other adjustments made at the end of a reporting period; and (iii) Consider the need to test journal entries and other adjustments throughout the period. (Ref: Para. A41–A44) (b) Review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. In performing this review, the auditor shall: (i) Evaluate whether the judgments and decisions made by management in making the accounting estimates included in the financial statements, even if they are individually reasonable, indicate a possible bias on the part of the entity's management that may represent a risk of material misstatement due to fraud. If so, the auditor shall reevaluate the accounting estimates taken as a whole; and (ii) Perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year. (Ref: Para. A45– A47) (c) For 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 and other information obtained during the audit, the auditor shall evaluate whether the business rationale (or the lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. (Ref: Para. A48)	**AU 316.58** 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: Obtain an understanding of the entity's financial reporting process and the controls over journal entries and other adjustments. (See paragraphs .59 and .60.) Identify and select journal entries and other adjustments for testing. (See paragraph .61.) Determine the timing of the testing. (See paragraph .62.) Inquire of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments.
240.22 The auditor shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related	**12.46** he 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

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to revenue accounts, may indicate risks of material misstatement due to fraud. **315.A7** Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold. **315.A8** Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud. **315.A9** However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.	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. **12.47** In applying analytical procedures as risk assessment procedures, the auditor should perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that might indicate a material misstatement, including material misstatement due to fraud. Also, when the auditor has performed a review of interim financial information in accordance with AU sec. 722, he or she should take into account the analytical procedures applied in that review when designing and applying analytical procedures as risk assessment procedures. **12.48** 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. 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.
MATERIAL MISSTATEMENTS DUE TO FRAUD **Auditor's Responsibilities Regarding Fraud: Engagement Team Discussion**	
240.15 ISA 315 requires a discussion among the engagement team members and a determination by the engagement partner of which matters are to be communicated to those team members not involved in the discussion.6 This discussion shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity. (Ref: Para. A10–A11)	**14.29** As part of this evaluation, the engagement partner should determine whether there has been appropriate communication with the other engagement team members throughout the audit regarding information or conditions that are indicative of fraud risks. Note: To accomplish this communication, the engagement partner might arrange another discussion among the engagement team members about fraud risks. (See paragraphs 49-51 of Auditing Standard No. 12.)
240.15 (see above)	**12.50** 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.
-	**14.29** (see above)
CONSIDERATION OF FRAUD **Fraud Risk Factors**	
240.A25 Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are presented in Appendix 1. These illustrative risk factors are classified based on the three conditions that are	**316.7** 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

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generally present when fraud exists: • An incentive or pressure to commit fraud; • A perceived opportunity to commit fraud; and • An ability to rationalize the fraudulent action. Risk factors reflective of an attitude that permits rationalization of the fraudulent action may not be susceptible to observation by the auditor. Nevertheless, the auditor may become aware of the existence of such information. Although the fraud risk factors described in Appendix 1 cover a broad range of situations that may be faced by auditors, they are only examples and other risk factors may exist.	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.
240.17 The auditor shall make inquiries of management regarding: (a) Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments; (Ref: Para. A12–A13) (b) Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist; (Ref: Para. A14) (c) Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and (d) Management's communication, if any, to employees regarding its views on business practices and ethical behavior. **240.18** The auditor shall make inquiries of management, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. (Ref: Para. A15–A17) **240.19** For those entities that have an internal audit function, the auditor shall make inquiries of internal audit to determine whether it has knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud. (Ref: Para. A18) **240.21** Unless all of those charged with governance are involved in managing the entity, the auditor shall make inquiries of those charged with governance to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. These inquiries are made in part to corroborate the responses to the inquiries of management. **240.A12** Management accepts responsibility for the entity's internal control and for the preparation of the entity's financial statements. Accordingly, it is appropriate for the auditor to make inquiries of management regarding management's own assessment of the risk of fraud and the controls in place to prevent and detect it. The nature, extent and frequency of management's assessment of such risk and controls may vary from entity to entity. In some entities, management may make detailed assessments on an annual basis or as part of continuous monitoring. In other entities, management's assessment may be less structured and less frequent. The nature, extent and frequency of management's assessment are relevant to the auditor's understanding of the entity's control environment. For example, the fact that management has not made an assessment of the risk of fraud may in some circumstances be indicative of the lack of importance that management places on internal control. **240.A16** Examples of others within the entity to whom the auditor may direct inquiries about the existence or suspicion of fraud include: • Operating personnel not directly involved in the financial reporting process. • Employees with different levels of authority. • Employees involved in initiating, processing or recording complex or unusual	**12.54** 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. **12.56** 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.

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transactions and those who supervise or monitor such employees. • In-house legal counsel. • Chief ethics officer or equivalent person. • The person or persons charged with dealing with allegations of fraud. **240.A19** Those charged with governance of an entity oversee the entity's systems for monitoring risk, financial control and compliance with the law. In many countries, corporate governance practices are well developed and those charged with governance play an active role in oversight of the entity's assessment of the risks of fraud and of the relevant internal control. Since the responsibilities of those charged with governance and management may vary by entity and by country, it is important that the auditor understands their respective responsibilities to enable the auditor to obtain an understanding of the oversight exercised by the appropriate individuals.	
240.A17 Management is often in the best position to perpetrate fraud. Accordingly, when evaluating management's responses to inquiries with an attitude of professional skepticism, the auditor may judge it necessary to corroborate responses to inquiries with other information.	**12.58** 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.
240.24 The auditor shall evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present. While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred and therefore may indicate risks of material misstatement due to fraud. (Ref: Para. A23–A27) **240.A23** The fact that fraud is usually concealed can make it very difficult to detect. Nevertheless, the auditor may identify events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud (fraud risk factors). For example: • The need to meet expectations of third parties to obtain additional equity financing may create pressure to commit fraud; • The granting of significant bonuses if unrealistic profit targets are met may create an incentive to commit fraud; and • A control environment that is not effective may create an opportunity to commit fraud.	**12.25** If the auditor identifies a control deficiency in the company's control environment, the auditor should evaluate the extent to which this control deficiency is indicative of a fraud risk factor, as discussed in paragraphs 65-66 of this standard.
240.15 ISA 315 requires a discussion among the engagement team members and a determination by the engagement partner of which matters are to be communicated to those team members not involved in the discussion. This discussion shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity. (Ref: Para. A10–A11) **240.A11** The discussion may include such matters as: • An exchange of ideas among engagement team members about how and where they believe the entity's financial statements may 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. […]	**12.52** 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

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	company's financial statements to material misstatement due to fraud.
CONSIDERATION OF FRAUD **Responses to risks of material misstatements due to fraud: Responses to assessed risks**	
-	**12.74** 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.
240.37 If the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud the auditor shall evaluate the implications for the audit. (Ref: Para. A53) **450.3** The objective of the auditor is to evaluate: (a) The effect of identified misstatements on the audit; and (b) The effect of uncorrected misstatements, if any, on 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.
-	**14.25.b** The following are examples of forms of management bias: 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.
CONSIDERATION OF FRAUD **Responses to risks of material misstatements due to fraud: Communication of Fraud**	
240.40 If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities. (Ref: Para. A60) **240.A60** When the auditor has obtained evidence that fraud exists or may exist, it is important that the matter be brought to the attention of the appropriate level of management as soon as practicable. This is so even if the matter might be considered inconsequential (for example, a minor defalcation by an employee at a low level in the entity's organization). The determination of which level of management is the appropriate one is a matter of professional judgment and is affected by such factors as the likelihood of collusion and the nature and magnitude of the suspected fraud. Ordinarily, the appropriate level of management is at least one level above the persons who appear to be involved with the suspected fraud. **260.7** Law or regulation may restrict the auditor's communication of certain matters with those charged with governance. For example, laws or regulations may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act. In some circumstances, potential conflicts between the auditor's obligations of confidentiality and obligations to communicate may be complex. In such cases, the auditor may consider obtaining legal advice.	**14.23** If the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred, he or she also must determine his or her responsibilities under AU secs. 316.79-.82A, AU sec. 317, and Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. § 78j-1. **316.79** 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.
450.7 If, at the auditor's request, management has examined a class of transactions, account balance or disclosure and corrected misstatements that were detected, the auditor	**14.16** 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,

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shall perform additional audit procedures to determine whether misstatements remain. (Ref: Para. A6)	the auditor should evaluate management's work to determine whether the corrections have been recorded properly and whether uncorrected misstatements remain.
CONSIDERATION OF FRAUD **Evaluation of Audit Evidence and Audit Documentation**	
540.A124 During the audit, the auditor may become aware of judgments and decisions made by management which give rise to indicators of possible management bias. Such indicators may affect the auditor's conclusion as to whether the auditor's risk assessment and related responses remain appropriate, and the auditor may need to consider the implications for the rest of the audit. Further, they may affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement, as discussed in ISA 700.	**14.26** 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.**
240.44 The auditor shall include the following in the audit documentation of the auditor's understanding of the entity and its environment and the assessment of the risks of material misstatement required by ISA 315:13 (a) The **significant decisions** reached **during the discussion** among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud; and (b) The **identified and assessed risks** of material misstatement **due to fraud** at the financial statement level and at the assertion level. **315.32** The auditor shall include in the audit documentation: (a) The **discussion** among the engagement team **where required** by paragraph 10, and the significant decisions reached; (b**) Key elements of the understanding** obtained regarding each of the aspects of the entity and its environment specified in paragraph 11 and of each of the internal control components specified in paragraphs 14– 24; the sources of information from which the understanding was obtained; and the **risk assessment procedures performed**; (c) The **identified and assessed risks** of material misstatement at the financial statement level and at the assertion level as required by paragraph 25; and (d) The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements in paragraphs 27–30. (Ref: Para. A131–A134) **230.8** The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand: (Ref: Para. A2–A5, A16–A17) (a) The nature, timing and extent of the **audit procedures** performed to comply with the ISAs and applicable legal and regulatory requirements; (Ref: Para. A6–A7) (b) The **results of the audit procedures** performed, and the **audit evidence** obtained; and (c) **Significant matters** arising during the audit, the **conclusions** reached thereon, and **significant professional judgments** made in reaching those conclusions. (Ref: Para. A8–A11)	**316.83** 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 52 and 53 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.) The **procedures performed** to obtain information necessary to identify and assess the fraud risks (See paragraph 47, paragraphs 56 through 58, and paragraphs 65 through 69 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.) The **fraud risks** that were **identified** at the financial statement and assertion levels (see paragraphs 59 through 69 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*), **and the linkage** of those risks **to the auditor's response** (see paragraphs 5 through 15 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement)*. If the auditor has not identified in a particular circumstance, improper revenue recognition as a fraud risk, the **reasons supporting** the auditor's **conclusion** (See paragraph 68 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.) The **results of the procedures** performed to address the assessed fraud risks, including those procedures performed to further address the risk of management override of controls (See paragraph 15 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatements*.) Other **conditions and analytical relationships** that caused the auditor to believe that additional auditing procedures or other responses were required and any further responses the auditor concluded were appropriate, to address such risks or other conditions (See paragraphs 5 through 9 of Auditing Standard No. 14, *Evaluating Audit Results*.) The **nature of the communications** about fraud made to management, the audit committee, and others (See paragraphs .79 through .82.)

Appendix 2: Abstract (English)

In most member states of the European Union (EU) the International Standards on Auditing (ISAs) – established by the International Auditing and Assurance Standards Board (IAASB) – are already in use and it is anticipated that the European Commission will adopt ISAs too. By comparison, the United States of America (U.S.) have their own auditing standards established by the Public Company Accounting Oversight Board (PCAOB) for companies listed in the U.S. Since a lot of non-U.S. companies, among them many from the EU, are listed at U.S. stock exchanges, there is a growing necessity for the compliance of PCAOB standards in addition to ISAs.

This thesis presents two comparative analyses of ISAs and the Auditing and Interim Standards by the PCAOB regarding material misstatements published by the PCAOB and the European Commission. On the basis of the two comparisons which were conducted in different years (published in 2009 and 2010 respectively) and covered different versions of standards, the standards where differences had been detected are compared again in the current versions of both standard sets. Moreover, the implications on statutory auditors in the EU having to comply with PCAOB standards in addition to ISAs are discussed.

The new comparison shows that the Clarity Project by the IAASB as well as Docket 026 by the PCAOB have reduced the differences between the two standard sets. Although the implications of these differences seem to be only little for EU statutory auditors, the comparison and filtering out of the differences between the two standard sets for complying with both simultaneously is complex and time-consuming. The inherent additional costs, time and complexity when applying PCAOB standards in addition to ISAs exceed the benefits of dual application. A recommendable future development would be the acceptance of financial statements of foreign private issuers audited in compliance with ISAs by the Security and Exchange Commission (SEC).

Appendix 3: Abstract (German)

In den meisten Mitgliedsstaaten der Europäischen Union (EU) werden bereits die internationalen Prüfungsstandards „International Standards on Auditing“ (ISAs), welche von dem International Auditing and Assurance Standards Board (IAASB) entwickelt wurden, verpflichtend angewendet, und es wird erwartet, dass die Europäische Kommission die ISAs ebenfalls übernehmen wird. Im Vergleich dazu schreiben die Vereinigten Staaten von Amerika ihre eigenen Prüfungsstandards des Public Company Accounting Oversight Board (PCAOB) börsennotierten Unternehmen vor. Da sehr viele nicht-US-amerikanische Unternehmen, darunter viele aus der EU, an US-amerikanischen Börsen notiert sind, gewinnt die Anwendung der PCAOB Prüfungsstandards zusätzlich zu den ISAs immer mehr an Bedeutung.

Diese Magisterarbeit stellt zwei Analysen vor, welche die ISAs mit den PCAOB Prüfungsstandards bezüglich wesentlicher Fehldarstellungen vergleicht, und von der PCAOB beziehungsweise der Europäischen Kommission publiziert wurden. Diese Studien sind in unterschiedlichen Jahren durchgeführt worden (2009 bzw. 2010 publiziert), wobei die verglichenen Prüfungsstandards von unterschiedlicher Auflage sind. Auf diesen basierend, sind alle von den beiden Analysen entdeckten Unterschiede erneut untersucht und die aktuellen Standards diesbezüglich verglichen worden. Des Weiteren sind die Auswirkungen auf Abschlussprüfer in der EU, welche die PCAOB Standards zusätzlich zu den ISAs anzuwenden haben, erörtert worden.

Die neue Vergleichsanalyse zeigt, dass das „Clarity Project“ des IAASB und „Docket 026“ des PCAOB die Unterschiede zwischen den beiden Standardsets reduziert haben. Obwohl die Auswirkungen auf die EU-Abschlussprüfer marginal erscheinen, ist das Vergleichen und Extrahieren der Unterschiede für die gleichzeitige Anwendung beider Standardsets sehr komplex und zeitintensiv. Die inhärenten zusätzlichen Kosten, die Zeit und die Komplexität für die gleichzeitige Einhaltung beider Standardsets übersteigen ihren zusätzlichen Nutzen. Eine empfehlenswerte zukünftige Entwicklung wäre die Akzeptanz von Jahresabschlüssen ausländischer Emittenten, welche nach ISAs geprüft wurden, seitens der US-Wertpapier- und Börsenaufsichtsbehörde „Security and Exchange Commission“ (SEC).

Appendix 4: Curriculum Vitae

PERSONAL DATA

Name:	Valentina METZ
Date of birth:	January 15, 1986
Place of birth:	Vienna, Austria
Citizenship:	Austrian
Academic degree:	Bachelor of Arts in Business Administration (B.A.)

EDUCATION

2008-2011	University of Vienna, Austria Master Programme in Corporate Finance, International Management and External Accounting
Summer 2009	London School of Economics Summer School Course: Analysis and Management of Financial Risk
2005-2008	University of Applied Sciences for Business and Engineering in Wiener Neustadt, Austria Bachelor in International Accounting and Finance
Autumn 2006	Exchange semester at the University of Warwick Warwick Business School, UK
2000-2005	Advanced-Level Secondary Vocational School, Biedermannsdorf Focusing on media informatics, text processing and publishing, accounting and business economics
1996-2000	Grammar School, Mödling
1992-1996	Elementary School, Südstadt

LANGUAGES

German	mother tongue
English	business level – oral and written
Italian	good – written, sufficient – oral

CERTIFICATES

ECDL	European Computer Driving License
IELTS	International English Language Testing System

PUBLICATIONS

Boss, M., Krenn, G., Metz, V., Puhr, C. und Schmitz, S. W.. *Systemically Important Accounts, Network Topology and Contagion in ARTIS.* Financial Stability Report 15, 93-111. Vienna: Oesterreichische Nationalbank, 2008.