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ASB meeting minutes, 2005, February 1-3; Auditing Standards Board approved highlights, 2005, February 1-3, meeting

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Recommended Citation

American Institute of Certified Public Accountants. Auditing Standards Board, "ASB meeting minutes, 2005, February 1-3; Auditing Standards Board approved highlights, 2005, February 1-3, meeting" (2005). *Association Sections, Divisions, Boards, Teams*. 128. https://egrove.olemiss.edu/aicpa_assoc/128

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AUDITING STANDARDS BOARD (ASB) MEETING
February 1-3, 2005
San Diego, CA
Approved Highlights

MEETING ATTENDANCE

ASB Members

John Fogarty , Chair
Harold Monk, Jr., Vice Chair
Barton Baldwin
Gerald Burns
Craig Crawford
George Fritz
James Goad
Daniel Goldwasser
Lynford Graham
George Rippey
Lisa Ritter
James Lee II
Wanda Lorenz (absent)
Keith Newton
William Messier, Jr.
Daniel Montgomery
Diane Rubin
Scott Seasock
Michael Umscheid

AICPA Staff

Ahava Goldman, Technical Manager, Audit and Attest Standards
Richard Miller, General Counsel & Trial Board
Chuck Landes, Director, Audit and Attest Standards
Hiram Hasty, Technical Manager, Audit and Attest Standards
Judith Sherinsky, Technical Manager, Audit and Attest Standards
Sharon Walker, Technical Manager, Audit and Attest Standards

Guests

Abe Akresh, *Government Accountability Office*
Julie Anne Dilley, *PriceWaterhouse Coopers LLP*
Bob Dohrer, *McGladrey & Pullen* (on Tuesday)
Tammy Mooney, *PPC*

Maria Manasses, *Grant Thornton*
Terry Hosey, *Ernst & Young*
Esmeralda Rodriguez, *SEC*
Tania Sergott, *Deloitte & Touche*

SAS 60

The Internal Control Task Force is revising Statement on Auditing Standards (SAS) No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, to reflect certain definitions and related guidance in Public Company Accounting Oversight Board Auditing Standard No. 2 (AS2), *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, (AS2). Michael Umscheid, chair of the task force, led the ASB in a discussion of a revised draft of the SAS. The ASB recommended that the task force:

- Differentiate, in a footnote to the phrase “more than inconsequential” in paragraph 3, the meaning of that phrase as the threshold for evaluating whether a significant deficiency exists as opposed to the threshold described in AU Section 312.41 of *Audit Risk and Materiality in Conducting an Audit*, for aggregating uncorrected misstatements to determine whether they are material to the financial statements
- Insert in paragraph 3 the definition of “inconsequential” found in the framework for assessing control deficiencies.
- Insert the word “potential” as a modifier of the word “misstatements” where applicable.
- Insert in the third bullet of paragraph 5, next to the term “compensating controls,” the definition of that term found in the framework for assessing control deficiencies.
- Move to paragraph 17:
 - The material in paragraph 7 that addresses multiple individually insignificant deficiencies that have a common theme, and delete the rest of paragraph 17
 - The guidance in paragraph 14 that addresses evaluating whether the aggregate effect of individual significant deficiencies results in a material weakness.
- Delete paragraph 9 which requires the auditor to report to management and those charged with governance situations in which the auditor has recommended controls that address significant deficiencies, and management has chosen not to implement them. (ASB Vote: Yes:17; No: 0)
- Retain paragraph 21 which requires the auditor to report each year existing significant deficiencies or material weaknesses in writing to management and those charged with governance if they have not yet been corrected.(ASB Vote: Yes:15, No: 2)

- Revise paragraph 22 to indicate that known significant deficiencies and material weaknesses, not communicated to management during the audit, need not be communicated to management prior to the issuance of the auditor's report as long as they are communicated on a timely basis. This reflects the guidance in SAS No. 61, *Communication With Audit Committees*. (ASB Vote: Yes: 13, No: 4)
- Delete paragraph 24 which addresses situations in which management is unable to prepare the final financial statements and either the auditor or someone outside the entity prepares the financial statements. The ASB debated the effect of such circumstances on the auditor's independence and on the entity's internal control. The ASB concluded that further consideration of this issue is needed, including the applicability of Ethics Interpretation 101-3, which relates to independence and is titled, "Performance of non-attest services." (ASB Vote Yes: 11 No: 6)
- Reword the language in paragraph 30, which describes the report to be used when the auditor has been requested to advise management and those charged with governance that no material weaknesses have been identified, because it implies that there were no significant deficiencies.
- Determine whether all of the matters included in Interpretation No. 1 of SAS No. 60, "Reporting on the Existence of Material Weaknesses," have been included in the proposed SAS.
- Ensure that the imperatives (must, should, required) in the proposed SAS correctly reflect the auditor's responsibilities and are in agreement with the proposed "clarity" SAS.
- Before SAS No. 60 is finalized, review AT 501, *Reporting on an Entity's Internal Control Over Financial Reporting*, for possible inconsistencies between the two standards since both address reporting on internal control

Clarity

Mr. Fogarty, Chair of the Clarity Task Force (task force), presented a proposed Statement on Auditing Standards (SAS) entitled *Defining Professional Requirements in Statements on Auditing Standards*.

Mr. Fogarty provided an update on the IAASB Clarity Exposure Draft. He noted that the comment period for the international standard ended on December 31, 2004. Comments received by the IAASB so far are varied. The international standard is significantly broader than the ASB exposure draft. The IAASB will consider its clarity project at its meeting in June 2005.

The ASB reviewed the proposed standard and noted the following:

- a. All SASs should be reviewed on a five year rotation plan based on the IAASB plan and amended as circumstances require.
- b. Requirements that state that the auditor “*generally* should” or “*ordinarily* should” are to be avoided.
- c. Wherever possible standards should be drafted using *must* rather than *is required*.
- d. *Must* is to be used for overarching principles rather than individual procedures.
- e. The terms defined in the proposed SAS will be used in drafting current work in process and will be applied to the audit documentation SAS currently in its exposure period. Further consideration is to be given to the application to the Audit Documentation that is currently in its exposure period.
- f. In applying the terms in the future, *must*, *is required* and *should*, will only be used in establishing requirements.
- g. The task force will prepare for exposure a proposed attestation standard to define requirements in attestation standards, consistent with the proposed SAS.

The ASB voted in favor of a ballot to issue this proposed SAS for exposure.

Risk Assessments

Mr. Darrel Schubert, co-chair of the risk assessments task force (task force), a joint project of the International Auditing and Assurance Standards Board (IAASB) and the ASB led a discussion of the status of the risk assessment project. See the appendix to these highlights for a description of the background of this project.

Mr. Schubert reported that the task force met on January 11-12, 2005 to discuss the Audit Risk and Materiality exposure draft and to review the status of all the other risk assessment exposure drafts. He discussed the significant issues and revisions related to the Audit Risk and Materiality exposure draft since it was issued in December 2002.

The significant issues discussed were:

1. Whether to separate the audit risk and materiality concepts into two separate standards, similar to the IAASB’s International Standards on Auditing (ISA) which separate the concepts into two standards, ISA 200, *Objective and General Principles governing an Audit of Financial Statements* and ISA 320 (revised), *Materiality in the Identification and Evaluation of Misstatements*. The task force recommended maintaining audit risk and materiality together in one standard because the issues are closely interrelated. The ASB agreed with the task force’s recommendation.
2. Whether to recommend the use of the ‘rollover’ method or the ‘iron curtain’ method in evaluating uncorrected misstatements. The rollover method considers the aggregate effect of prior period and current period uncorrected misstatements, while the iron curtain method only considers the effect of the current period’s uncorrected misstatements. The revised exposure draft discusses the requirement that the auditor should consider the effect of misstatements related to prior periods

in evaluating audit differences.¹ This requirement was based on the guidance in the ISA 320 exposure draft. The task force's view is that the guidance contained in the ISA 320 exposure draft could be interpreted to require the auditor to consider both methods in evaluating audit findings and correct any individual material misstatement under either method. The task force was agreement with this. After discussion, the ASB agreed with the task force's view, but directed to revise the wording of this guidance. The ASB also directed the staff to a) write a comment letter to the IAASB on this issue and b) appoint a delegation to discuss this issue with other stakeholders of the profession such as, the Financial Accounting Standards Board, the Financial Executive Institute and others.

Significant changes made to the Audit Risk and Materiality were as follows:

1. Reflect comments arising from the comment letters. In total, there were thirty-one comment letters received.
2. Reflect revisions made by the IAASB to the ISA exposure drafts in finalizing its International Standards on Auditing.
3. Reflect changes arising from the Public Company Accounting Oversight Board's (PCAOB), *Conforming Amendments to PCAOB Interim Standards Resulting from Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* of the PCAOB's conforming changes that may warrant conforming changes to SASs.
4. Changes to align the Audit Risk and Materiality exposure draft with the proposed ISA 320. The proposed ISA 320 contained several elements such as, discussion of users, use of percentages of benchmarks, discussion of tolerable misstatement, etc, that were missing from the audit risk and materiality exposure draft. The revised exposure draft incorporates these missing elements.
5. Other – Other revisions were made by the task force to better explain certain terms and reflect certain issues that have emerged since the exposure draft and the ISAs were issued.

Future Actions

The task force is scheduled to meet on February 23, 2005 to discuss revisions to the Planning and Supervision exposure draft and finalize the other risk assessment proposed standards. The task force expects to present the entire suite of the risk assessment proposed standards at the next ASB meeting scheduled for April 26-28, 2005 for the ASB's consideration to approve the proposed standards for re-exposure.

¹ See paragraph 51 of the revised Audit Risk and Materiality exposure draft.

**Risk Assessment Project
Background Information**

On December 2, 2002 the ASB issued an exposure draft of a suite of seven proposed Statements on Auditing Standards (SASs) relating to the auditor's risk assessment process. The exposure draft consists of the following proposed SASs:

- *Amendment to Statement on Auditing Standards No. 95, Generally Accepted Auditing Standards*
- *Audit Evidence*, which would supersede SAS No. 31, *Evidential Matter* (AU sec. 326)
- *Audit Risk and Materiality in Conducting an Audit*, which would supersede SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU sec. 312)
- *Planning and Supervision*, which would supersede "Appointment of the Independent Auditor" (AU sec. 310), and SAS No. 22, *Planning and Supervision* (AU sec. 311)
- *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (Assessing Risks)*
- *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, which would supersede SAS No. 45, *Substantive Tests Prior to the Balance-Sheet Date* (AU sec. 313), and, together with the proposed SAS *Assessing Risks* would supersede SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AU sec. 319)
- *Amendment to SAS No. 39, Audit Sampling*

In October 2003, the IAASB completed the international phase of the risk-assessment project by issuing the following three International Standards on Auditing (ISA):

- ISA 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- ISA 330, *The Auditor's Procedures in Response to Assessed Risks*
- ISA 500, *Audit Evidence*.

In June 2004, the IAASB issued ISA 300 (revised), *Planning an Audit of Financial Statements*. In addition, on December 20, 2004, the IAASB has approved the issuance of the proposed exposure draft ISA 320 (revised), *Materiality in the Identification and Evaluation of Misstatements*.

AT 501

The Internal Control Task Force is revising AT 501, *Reporting on an Entity's Internal Control Over Financial Reporting*, to incorporate certain terminology and related guidance in Public Company Accounting Oversight Board Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*, (AS2). Mike Umscheid, chair of the task force, presented a table comparing the paragraphs in a proposed revision of AT 501 with corresponding paragraphs in AS2. The draft of the proposed revision of AT 501 reflects a recommendation by the Audit Issues Task Force that revised AT 501 fit within the existing framework of Statements on Standards for Attestation Engagements found in AT 101, *Attest Engagements*. The following are some of the features of the proposed revision of AT 501:

- The recommended criteria for an AT 501 engagement would be the Internal Control – Integrated Framework developed by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission; although, other suitable criteria could be used.
- Management would have to achieve reasonable assurance regarding the effectiveness of the entity's internal control over financial reporting (internal control).
- Management could achieve that assurance by:
 - Documenting its internal control
 - Monitoring its internal control (a component of COSO)
 - Documenting the results of its monitoring.
- The practitioner may not perform the engagement if there is insufficient documentation of the entity's internal control.
(Issue: Could an individual outside the entity document the entity's internal control, for example, the practitioner or another CPA?). Also, what effect would this have on the evaluation of internal control? Would the entity's inability to document internal control be considered a material weakness?)
- Management would make an assertion about the effectiveness of the entity's internal control based on the COSO criteria.
- Management's findings, resulting from its monitoring, would provide management with a basis for assessing its internal control and for making an assertion about its effectiveness.
- Management's monitoring activities also would provide evidence concerning the effectiveness of the other four components of internal control (control environment, risk assessment, control activities and information and communication.)
- Under COSO, management is responsible for designing, implementing, and testing the effectiveness of internal control over financial reporting so that it can demonstrate that internal control over financial reporting provides reasonable assurance that the financial statements are fairly stated. Management would be required to document the results of its testing.
- If management's work effort and documentation of the effectiveness of the entity's internal control is not sufficient to support management's assertion, the practitioner would conclude that management has not effectively monitored and that internal control is not effective. In these circumstances, the practitioner would issue an

adverse report and could continue to identify any other significant deficiencies and material weaknesses in internal control by performing his or her own testing.

- The objective of this approach is to enable the practitioner to identify the significant deficiencies and material weaknesses in internal control and bring them to management's attention with the expectation that management will begin to remediate these deficiencies, and generate sufficient evidence regarding the effectiveness of internal control.
- The practitioner cannot make up for management's lack of support for its assertion; accordingly, the practitioner's work would not affect the report. (It would still be an adverse opinion).
- If management provides a dirty assertion ("Internal control is not effective."), the practitioner should report directly on the subject matter, not on management's assertion.
- Unlike AS2, the examination of internal control would not be integrated with the audit of the financial statements. That is, the practitioner who performs the examination of internal control does not need to be the auditor who audits the financial statements. The following are other comments related to this matter:
 - There will need to be guidance for (1) situations in which the practitioner performs the audit of the financial statements and the examination of internal control, and (2) situations in which two different practitioners perform these engagements
 - Do the financial statements have to be audited for the practitioner to examine the entity's internal control? Can a practitioner achieve a high level of assurance on internal control without auditing the financial statements?
 - A practitioner who has not audited the financial statements should be required to gain sufficient audit level knowledge to perform the examination of internal control.
 - The auditor of the financial statements and the practitioner performing the examination of internal control should be required to communicate with each other.
 - If both engagements have been performed, the reports should bear the same dates. It would be problematic if the report on the audit of the financial statements is issued first, and the report on the examination of internal control is issued later and indicates that internal control is not effective.
- An examination of internal control could be for a point in time or a period.
- In the proposed revision of AT 501, the practitioner may report on design or on design and operating effectiveness.
- In an engagement that covers only design effectiveness, the practitioner would not test the effectiveness of controls; instead, the practitioner would use inquiry of appropriate personnel, inspection of documents and records, and observation of entity activities and operations to evaluate the suitability of design.
- Examples of potential users of AT 501 reports are:
 - FDICIA
 - Insurance industry
 - GAO
 - Non profit community

- Private companies that wish to go public
- Louisiana regulators of casinos who require those entities to submit reviewed financial statements and examination level assurance on internal control.
- The ASB concluded that:
 - Management should present its written assertion about the effectiveness of internal control in a separate report and in its representation letter. (ASB Vote:11 Yes; 6 No)
 - A practitioner should have the option of issuing a qualified opinion in addition to an adverse opinion (ASB Vote: No: 14;Yes: 3)
 - A practitioner must state all the reasons for his or her conclusion.
 - The task force should consider including in AT 501 applicable Q's and A's issued by the PCAOB, as well as the appendices in AS2, including appendix E.
 - The task force should develop a revised draft of AT 501 for discussion at the April 2005 ASB meeting.

Specialists

Mr. Michael Umscheid presented this matter to the ASB. The objective of the project was to revise SAS No. 73, *Using the Work of a Specialist* by replacing it with two Statements: 1) *Using an Outside Specialist to Assist in the Audit* (Auditor's Specialist) and 2) *Using the Work of Management's Nonemployee Specialist* (Management's Specialist). In December 2004, the International Auditing and Assurance Standards Board (IAASB) added a project to its agenda to revise ISA 620, *Using the Work of an Expert*. The ASB expressed its willingness to share its work product with the IAASB in order to assist the IAASB's project in this regard. The Board was asked to approve the draft statements for submission to the IAASB.

Mr. Umscheid led a discussion of the significant revisions made by the task force in response to comments received at the September 2004 ASB meeting.

At the February 2005 meeting, the ASB:

- Directed the task force to revise the wording of the guidance in relation to determining whether the specialist is on the audit team and eliminate some of the criteria suggested by the task force.
- Questioned whether the definition of audit firm, taken from the AICPA's Statement on Quality Standards No. 2, includes affiliates or associations of the audit firms.
- Directed the task force to revise the Auditor's Specialists and the Management's Specialists recommendations and to write a transmittal letter to go along with the submission to the IAASB providing a commentary of the significant issues discussed by the ASB and the task force. Subject to this, the ASB approved the two recommendations for submission to the IAASB.