2003

Proposed statement on auditing standards : Sarbanes-Oxley omnibus statement on auditing standards;Sarbanes-Oxley omnibus statement on auditing standards

American Institute of Certified Public Accountants. Auditing Standards Board

EXPOSURE DRAFT

PROPOSED STATEMENT ON AUDITING STANDARDS

Sarbanes-Oxley Omnibus Statement on Auditing Standards

APRIL 1, 2003

Prepared by the AICPA Auditing Standards Board for comment from persons interested in auditing and reporting issues

Comments should be sent via the Internet to Sherry Boothe at sboothe@aicpa.org and received by May 15, 2003

April 1, 2003

Accompanying this letter is an exposure draft of a proposed Statement on Auditing Standards (SAS) entitled *Sarbanes-Oxley Omnibus Statement on Auditing Standards*. This proposed Statement reflects amendments to various standards to reflect certain provisions of the Sarbanes-Oxley Act of 2002 and the final Securities and Exchange Commission rules entitled *Retention of Records Relevant to Audits and Reviews*, and *Strengthening the Commission's Requirements Regarding Auditor Independence*. This exposure draft:

1. Proposes a new SAS, *Review of SEC Engagements by a Reviewing Partner,* that sets a requirement for SEC engagements for a review by a reviewing partner of the audit of financial statements and, where applicable, the review of interim financial information and the audit of internal control over financial reporting (as required by the proposed SAS, *Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit*).

2. Amends the following:

a. AU sec. 310, *Appointment of the Independent Auditor* (AICPA, *Professional Standards,* vol. 1, AU sec. 310)

b. AU sec. 315, *Communication Between Successor and Predecessor Auditors* (AICPA, *Professional Standards,* vol. 1, AU sec. 315)

c. AU sec. 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards,* vol. 1, AU sec. 316)

d. AU sec. 333, *Management Representations* (AICPA, *Professional Standards,* vol. 1, AU sec. 333)

e. AU sec. 334, *Related Parties* (AICPA, *Professional Standards,* vol. 1, AU sec. 334)

f. AU sec. 339, *Audit Documentation* (AICPA, *Professional Standards,* vol. 1, AU sec. 339), to set requirements for record retention

g. AU sec. 380, *Communication With Audit Committees* (AICPA, *Professional Standards,* vol. 1, AU sec. 380)

h. AU sec. 722, *Interim Financial Information* (AICPA, *Professional Standards,* vol. 1, AU sec. 722)

A summary of the significant provisions of the proposed SAS accompanies this letter.

Comments or suggestions on any aspect of this exposure draft will be appreciated. To facilitate the Auditing Standards Board's (ASB) consideration of responses, comments should refer to specific paragraphs and include supporting reasons for each suggestion or comment.

In developing guidance, the ASB considers the relationship between the cost imposed and the benefits reasonably expected to be derived from audits. It also considers the differences the auditor may encounter in the audit of financial statements of small businesses and, when appropriate, makes special provisions to meet those needs. Therefore, the ASB would particularly appreciate comments on those matters.

Comments will become part of the public record of the AICPA and will be available for public inspection at the offices of the AICPA after June 17, 2003, for one year. Comments should be sent via the Internet to Sherry Boothe, Audit and Attest Standards, at sboothe@aicpa.org and received no later than May 15, 2003.

Sincerely,

James S. Gerson
Chair
Auditing Standards Board

Charles E. Landes
Director
Audit and Attest Standards

SUMMARY

WHY ISSUED

This proposed Statement on Auditing Standards (SAS) was issued to address certain provisions of the Sarbanes-Oxley Act of 2002 (the Act).

This proposed SAS creates a new requirement in the auditing standards for SEC engagements for a review by a reviewing partner (often referred to as a concurring partner) of the audit of financial statements and, where applicable, the review of interim financial information. Previously, these requirements were contained in the rules of the AICPA's SEC Practice Section. This proposed SAS also sets a new requirement for the review by a reviewing partner of the audit of internal control over financial reporting required by the proposed SAS, *Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit*.

The proposed SAS also amends SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards,* vol. 1, AU sec. 339), and SAS No. 100, *Interim Financial Information* (AICPA, *Professional Standards,* vol. 1, AU sec. 722), to incorporate a requirement of the Act to retain certain audit and review documentation for a period of seven years from the end of the audit or review period. This requirement is consistent with the final SEC rule entitled *Retention of Records Relevant to Audits and Reviews*, which was issued in January 2003.

This proposed SAS also amends various AU sections to reflect the impact of various provisions of the Act on existing auditing standards.

WHAT IT DOES

Review of SEC Engagements by a Reviewing Partner
As required by the Act, this exposure draft would establish a new requirement within auditing standards for the review of SEC engagements by a reviewing partner. Such review includes (1) the audit of the financial statements, (2) reviews of interim financial information performed in accordance with SAS No. 100 and (3) the audit of internal control performed in conjunction with the financial statement audit pursuant to the proposed SAS, *Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit*. This proposed SAS:

- Provides guidance on the responsibilities and objectives of the reviewing partner's review. With respect to the audit of financial statements, the reviewing partner's objective is to conclude that no matters have come to his or her attention that would cause him or her to believe that the financial statements are not in conformity with generally accepted accounting principles in all material respects, or that the audit was not performed in accordance with generally accepted auditing standards. With respect to the review of interim financial information, the reviewing partner's objective is to conclude that no matters have come to his or her attention that would cause him or her to believe that material modifications should be made to the interim financial information for it to be in conformity with generally accepted accounting principles, or that the review was not performed in accordance with SAS No. 100. With respect to the audit of internal control, the reviewing partner's objective is to conclude that no matters have come to his or her attention that would cause him or her to believe that management's assertion about internal control is not fairly stated, in all material respects, based upon suitable criteria, or that the audit was not performed in accordance with generally accepted auditing standards. In each case, the reviewing partner bases his or her conclusions on all relevant facts and circumstances of which the reviewing partner has knowledge.

- Provides guidance on the necessary qualifications for a reviewing partner. The reviewing partner should have sufficient technical expertise and experience to achieve the objectives described above. The determination of what constitutes sufficient technical expertise and experience requires professional judgment and is based on the circumstances of the engagement. The reviewing partner should possess knowledge of applicable specialized industry practices and of relevant SEC rules and regulations. When necessary, the reviewing partner should seek assistance from other individuals to supplement this knowledge.

- Identifies procedures the reviewing partner should perform in the review of the audit of the financial statements. Those procedures include the following:
  - — Discussing significant auditing, accounting, and financial reporting matters with the lead audit partner
  - — Discussing with the lead audit partner the audit team's identification and audit of significant risks
  - — Reviewing documentation of audit findings or issues that are significant, including actions taken to address them, and the basis for the final conclusions reached
  - — If others in the firm were involved in consultations on significant auditing, accounting, or financial reporting matters, discussing the resolution of such matters with the individuals involved in those consultations, or reviewing documentation of such consultation, including the resulting resolution
  - — Reviewing a summary of uncorrected financial statement misstatements
  - — Reading the financial statements and auditors' report
  - — Confirming with the lead audit partner that there are no significant unresolved matters
  - — Reading other information in documents covered by SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550), and SAS No. 37, *Filings Under Federal Securities Statutes* (AICPA, *Professional Standards*, vol. 1, AU sec. 711)

- States that the reviewing partner's procedures with respect to reviews of interim financial information performed in accordance with SAS No. 100 are similar to those described in SAS No. 100.

- Identifies procedures the reviewing partner should perform in the review of the audit of internal control. The reviewing partner's responsibility is fulfilled by performing the following procedures:
  - — Discussing with the lead audit partner significant internal control and related reporting matters
  - — Discussing with the lead audit partner the audit team's identification and audit of significant internal controls
  - — Reviewing conclusions about whether identified internal control deficiencies constitute significant deficiencies or material weaknesses
  - — If others in the firm were involved in consultations on significant internal control and related reporting matters, discussing the resolution of such matters with the individuals involved in those consultations, or reviewing documentation of such consultation, including the resulting resolution
  - — Reading management's assertion about the effectiveness of internal control over financial reporting and the auditors' report thereon
  - — Confirming with the lead audit partner that there are no significant unresolved matters

- Sets documentation requirements. Audit documentation should demonstrate that the review procedures required by this SAS have been performed, and include the reviewing partner's conclusions that no matters came to his or her attention that would cause him or her to believe that: (a) the financial statements are not in conformity with generally accepted accounting principles in all material respects, or that the audit was not performed in accordance with generally accepted auditing standards; (b) material modifications should be made to the interim financial information for it to be in conformity with generally accepted accounting principles, or that the review was not performed in accordance with SAS No. 100; or (c) management's assertion about internal control is not fairly stated, in all material respects, based upon suitable criteria, or that the audit was not performed in accordance with generally accepted auditing standards.

AU Section 310, *Appointment of the Independent Auditor*
This proposed Statement amends AU sec. 310, *Appointment of the Independent Auditor* (AICPA, *Professional Standards,* vol. 1, AU sec. 310), to include the following:

- For entities subject to Section 10A of the Securities Exchange Act of 1934 (the 1934 Act), the audit committee is directly responsible for the appointment, compensation, and oversight of the work of the auditor (including resolution of disagreements between management and the auditor regarding financial reporting), and that the auditor reports directly to the audit committee. Therefore, for audits of such entities, the audit committee (or the entire board of directors if there is no audit committee) ordinarily engages the auditor on behalf of the entity and its shareholders. For other entities, if the entity has an audit committee, the audit committee would normally engage the auditor.

- The auditor is required to document the understanding with the client through a written communication (engagement letter), preferably signed by both the auditor and the client.

- Matters to be included in the understanding have been expanded to include the following, among other things:

  — The auditor is also responsible to determine that certain other matters related to the conduct of the audit are communicated to the audit committee, including (1) fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statement, (2) illegal acts that come to his or her attention (unless they are clearly inconsequential), (3) disagreements with management and other serious difficulties encountered in performing the audit, and (4) various matters related to the entity's accounting policies and financial statements.
  — Management is responsible for informing the auditor of all significant deficiencies in the design or operation of internal control over financial reporting of which it has knowledge.
  — Management is responsible for informing the auditor of any known material violations of laws or regulations applicable to its activities.
  — Management is responsible for the design and implementation of programs and controls to prevent and detect fraud, and for informing the auditor about all known or suspected fraud affecting the entity involving (1) management, (2) employees who have significant roles in internal control, and (3) others where the fraud could have a material effect on the financial statements. Management is also responsible for informing the auditor of its knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, analysts, regulators, short sellers, or others.

- If applicable, the auditor should establish an understanding with the client regarding the audit of internal control in accordance with the proposed SAS, *Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit*. This amendment includes a listing of the matters that should be included in that understanding.

AU Section 315, *Communication Between Successor and Predecessor Auditors*

This proposed Statement amends AU sec. 315, *Communication Between Successor and Predecessor Auditors* (AICPA, *Professional Standards,* vol. 1, AU sec. 315), to revise AU sec. 315.21 and add new footnotes 10 and 11. During an audit or reaudit of financial statements, the successor auditor may become aware of information that leads him or her to believe that financial statements reported on by a predecessor auditor may require revision. The successor auditor should not report on revised audited financial statements prior to communicating to the predecessor auditor the information described in AU sec. 315.21.

AU Section 316, *Consideration of Fraud in a Financial Statement Audit*

This proposed Statement amends AU sec. 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards,* vol. 1, AU sec. 316), to require the auditors of entities subject to Section 10A of the 1934 Act to inquire of audit committees as to the procedures placed in operation and complaints received or concerns expressed as a result of established procedures for (1) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and (2) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.

AU Section 333, *Management Representations*

This proposed Statement amends AU sec. 333.06 of *Management Representations* (AICPA, *Professional Standards,* vol. 1, AU sec. 333), to add the following matter to which specific management representations should relate: Disclosure of all significant deficiencies, including material weaknesses, in the design or operation of internal controls that could adversely affect the entity's ability to record, process, summarize, and report financial data. Also, if, in a public company audit, the auditor chooses to obtain a combined representation letter related to the audit of financial statements and the audit of internal control, the auditor should obtain additional representations relevant to the audit of internal control contained in AT sec. 501.44 of *Reporting on an Entity's Internal Control Over Financial Reporting* (AICPA, *Professional Standards,* vol. 1, AT sec. 501).

AU Section 334, *Related Parties*

This proposed Statement amends AU sec. 334, *Related Parties* (AICPA, *Professional Standards,* vol. 1, AU sec. 334), to add new footnote 6 to AU sec. 334.09. New footnote 6 states that related party transactions may represent illegal acts. For example, certain loans to a director or an executive officer of a public company may be prohibited by the Exchange Act.

AU Section 339, *Audit Documentation*

As required by the Act and pursuant to the recently issued SEC rule, *Retention of Records Relevant to Audits and Reviews*, this proposed Statement amends AU sec. 339, *Audit Documentation* (AICPA, *Professional Standards,* vol. 1, AU sec. 339), to incorporate records retention requirements in the auditing standards. AU sec. 339 states that the auditor should adopt reasonable procedures to retain audit documentation and certain other records for at least a period of seven years after the auditor concludes the audit.

AU Section 380, *Communication With Audit Committees*

This proposed Statement amends AU sec. 380, *Communication With Audit Committees* (AICPA, *Professional Standards,* vol. 1, AU sec. 380), to include the following:

- An audit committee is defined as a committee (or equivalent body, such as a finance committee or a budget committee) established by and among the board of directors or other governing body for the purpose of overseeing the accounting and financial reporting processes of the entity and audits of the financial statements of the entity or for SEC engagements, if no such committee exists, the entire board of directors.

- Updates the definition of an SEC engagement (see footnote 2) based on the recent revision of the SEC Practice Section Reference Manual
- In connection with SEC engagements, the auditor should:
  - — Report to the audit committee all of the entity's critical accounting policies and practices applied in its financial statements and the auditor's assessment of management's disclosures regarding such policies and practices, the reasons why certain policies and practices are or are not considered critical, and how current and anticipated future events impact those determinations.
  - — Report to the audit committee all alternative treatments within generally accepted accounting principles for accounting policies and practices related to material items, including recognition, measurement, presentation, and disclosure alternatives that have been discussed with management during the current audit period, the ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the auditor; and, if an accounting policy selected by the client is not the policy preferred by the auditor, the auditor should inform the audit committee of the reasons why management selected that policy, the policy preferred by the auditor, and the reason he or she preferred the other policy.
  - — Discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the entity's accounting policies as applied in its financial reporting.
- Defines critical accounting policies and practices as those that (1) are disclosed as critical accounting policies within management's discussion and analysis, or (2) in the auditor's judgment, are both most important to the portrayal of the entity's financial condition and results of operations and require management's most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.

- Defines alternative treatments within generally accepted accounting principles for accounting policies and practices related to material items to include both those accounting principles for which different accounting policies and practices are generally accepted (for example, inventory pricing methods, depreciation methods, and the method of accounting for stock based compensation), and those for which no authoritative accounting literature exist.

- Requires the auditor to determine that the audit committee has received copies of all material written communications between the auditor and management, such as engagement letters, management representation letters, reports issued on significant deficiencies or material weaknesses, and written communications on accounting, auditing, internal control, or operational matters.

- For SEC engagements, the matters required to be communicated about management judgments and accounting estimates, uncorrected misstatements, accounting policies and alternative treatments, and significant written communications between the auditor and management should be communicated to the audit committee prior to the filing of the auditor's report with the appropriate regulatory agency. The auditor should also attempt to make the other required communications prior to the filing of the auditor's report with the appropriate regulatory agency; however, if such communications cannot be made prior to the filing, they should be made as soon as practicable in the circumstances.

AU Section 722, *Interim Financial Information*

As required by the Act and pursuant to the recently issued SEC rule, *Retention of Records Relevant to Audits and Reviews*, this proposed Statement amends AU sec. 722, *Interim Financial Information* (AICPA, *Professional Standards,* vol. 1, AU sec. 722)*,* to incorporate records retention requirements in the auditing standards. AU sec. 722 states that an accountant should adopt reasonable procedures to retain review documentation for a period of seven years after the accountant concludes the audit of financial statements of the fiscal year including the period under review (or, if no such report is issued, from completion of the review procedures for the last interim period reviewed within that fiscal year) and for such additional period of time sufficient to satisfy any applicable legal or regulatory requirements for record retentions. It also adds new paragraph 54 to note that the proposed SAS, *Review of SEC Engagements by a Reviewing Partner*, states that the reviewing partner's review should also include reviews on interim financial information filed in the company's quarterly reports on Form-10-Q or Form 10-QSB during the period under audit.

EFFECTIVE DATES

The proposed amendments that relate to SEC engagements would have varying effective dates generally based on the effective dates of certain SEC rules. For non-SEC engagements, the proposed amendments generally would be effective for periods beginning after December 15, 2003.

HOW IT AFFECTS EXISTING STANDARDS

The exposure draft would result in a new SAS that would amend:

- AU sec. 310, *Appointment of the Independent Auditor*
- AU sec. 315, *Communication Between Successor and Predecessor Auditors*
- AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*
- AU sec. 333, *Management Representations*
- AU sec. 334, *Related Parties*
- AU sec. 339, *Audit Documentation*
- AU sec. 380, *Communication With Audit Committees*
- AU sec. 722, *Interim Financial Information*

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PROPOSED STATEMENT ON AUDITING STANDARDS REVIEW OF SEC ENGAGEMENTS BY A REVIEWING PARTNER[1]

Introduction

1. This statement establishes standards for SEC engagements[2] for a review to be performed by a reviewing partner[3] of the audit of the entity's financial statements and, where applicable, the review of the entity's interim financial information in accordance with Statement on Auditing Standards (SAS) No. 100, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 722), and the audit of the entity's internal control over financial reporting in accordance with the proposed SAS, *Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit*. The review performed by the reviewing partner serves as an objective review of significant auditing, accounting, and financial reporting matters[4] and, where applicable, of significant internal control and related reporting matters that come to the attention of the reviewing partner. This statement also provides guidance on the responsibilities and qualifications of the reviewing partner, the review procedures to be performed, and related documentation requirements.

Responsibilities of the Reviewing Partner

2. With respect to the audit of financial statements, the reviewing partner's objective is to conclude that no matters have come to his or her attention that would cause him or her to believe that the financial statements are not in conformity with generally accepted accounting principles in all material respects, or that the audit was not performed in accordance with generally accepted auditing standards. With respect to the review of interim financial information, the reviewing partner's objective is to conclude that no matters have come to his or her attention that would cause him or her to believe that material modifications should be made to the interim financial information for it to be in conformity with generally accepted accounting principles, or that the review was not performed in accordance with SAS No. 100. With respect to the audit of internal control, the reviewing partner's objective is to conclude that no matters have come to his or her attention that would cause him or her to believe that management's assertion about internal control is not fairly stated, in all material respects, based upon suitable criteria, or that the audit was not performed in accordance with generally accepted auditing standards. In each case, the reviewing partner bases his or her conclusions on all relevant facts and circumstances of which the reviewing partner has knowledge.

3. The reviewing partner's responsibility is not the equivalent of the responsibility of the lead audit partner (defined herein to mean the auditor with final responsibility for the audit). Without first-hand knowledge of the entity's business environment, the benefit of discussions with management and other entity personnel, the opportunity to review entity documents or controls, or the ability to observe management's actions or attitudes, a reviewing partner generally is not in a position to make the informed judgments on significant issues expected of the lead audit partner. However, the reviewing partner should reach conclusions based on all relevant facts and circumstances of which he or she has knowledge.

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[1] A reviewing partner is also referred to as a *concurring partner* in the SEC rules.

[2] See note 2 of SAS No. 60, *Communication With Audit Committees*, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 380), for the definition of SEC engagements.

[3] A partner is a proprietor, shareholder, equity or non-equity partner or any individual who assumes the risks and benefits of firm ownership or who is otherwise held out by the firm to be the equivalent of any of the aforementioned. If no other partner within the firm has the necessary qualifications for a reviewing partner, use of a partner of another accounting firm who meets the necessary qualifications for a reviewing partner is not precluded.

[4] For purposes of the reviewing partner review, the term *significant auditing, accounting, and financial reporting matters* refers to matters involving a significant risk of material misstatement of financial statements, including a material disclosure deficiency.

4. The reviewing partner is expected to objectively perform the procedures specified below. These procedures provide the basis for the reviewing partner to perform an objective review of the findings or issues that were considered to be significant by the audit team. The reviewing partner is not responsible for searching for additional matters to be considered by the audit team. However, significant matters not previously identified by the audit team that come to the reviewing partner's attention should be referred to and resolved by the audit team with the concurrence of the reviewing partner.

5. If the reviewing partner and the lead audit partner have a difference of opinion regarding a significant finding or issue, the difference of opinion should be resolved in accordance with applicable firm policy.

Qualifications of the Reviewing Partner

6. The reviewing partner should have sufficient technical expertise and experience to achieve the objectives described above. The determination of what constitutes sufficient technical expertise and experience requires professional judgment and is based on the circumstances of the engagement. The reviewing partner should possess knowledge of applicable specialized industry practices and of relevant SEC rules and regulations. When necessary, the reviewing partner should seek assistance from other individuals to supplement this knowledge.

7. The reviewing partner should carry out his or her responsibilities with objectivity and due professional care. Further, the reviewing partner should not assume any of the responsibilities of the lead audit partner, or have responsibility for the audit of any significant subsidiaries, divisions, benefit plans, or affiliated or related entities. It is not unusual for clients to be aware of the existence of a reviewing partner. A client may contact the reviewing partner with respect to matters requiring immediate attention when the lead audit partner is not available. When a reviewing partner is thus required to deal with an auditing, accounting, internal control, or reporting matter, he or she should advise the lead audit partner of the facts and circumstances so that the lead audit partner can review the matter and take full responsibility for its resolution.

Review of the Audit of the Financial Statements

8. The reviewing partner's responsibility for the review of the audit of the financial statements is fulfilled by performing the following procedures:

- Discussing with the lead audit partner significant auditing, accounting, and financial reporting matters
- Discussing with the lead audit partner the audit team's identification and audit of significant risks
- Reviewing documentation of audit findings or issues that are significant, including actions taken to address them, and the basis for the final conclusions reached[5]
- If others in the firm were involved in consultations on significant auditing, accounting, or financial reporting matters, discussing the resolution of such matters with the individuals involved in those consultations, or reviewing documentation of such consultation, including the resulting resolution
- Reviewing a summary of uncorrected financial statement misstatements
- Reading the financial statements and auditors' report
- Confirming with the lead audit partner that there are no significant unresolved matters
- Reading other information in documents covered by SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550), and SAS No. 37, *Filings Under Federal Securities Statutes* (AICPA, *Professional Standards*, vol. 1, AU sec. 711)

[5] Documentation to be reviewed may include selected, more detailed documentation. The review of more detailed documentation is a matter of professional judgment made by the reviewing partner. See SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339.09).

Review of the Review of Interim Financial Information

9. The reviewing partner's procedures with respect to reviews of interim financial information performed in accordance with SAS No. 100 are similar to those described in paragraph 8.

Review of the Audit of Internal Control

10. The reviewing partner's responsibility for the review of the audit of internal control is fulfilled by performing the following procedures:

- Discussing with the lead audit partner significant internal control and related reporting matters
- Discussing with the lead audit partner the audit team's identification and audit of significant internal controls
- Reviewing conclusions about whether identified internal control deficiencies constitute significant deficiencies or material weaknesses
- If others in the firm were involved in consultations on significant internal control and related reporting matters, discussing the resolution of such matters with the individuals involved in those consultations, or reviewing documentation of such consultation, including the resulting resolution
- Reading management's assertion about the effectiveness of internal control over financial reporting and the auditors' report thereon[6]
- Confirming with the lead audit partner that there are no significant unresolved matters

Timing

11. In all cases, the reviewing partner's review should be completed before the issuance of the audit reports on the financial statements and internal control, or before the filing of the Form 10-Q or Form 10-QSB, or such other filing, containing the interim financial information, and before the reisssuance of audit reports where performance of subsequent event procedures[7] is required by professional standards.

Documentation

12. Audit documentation should demonstrate that the review procedures required by this statement have been performed and include, as applicable, the reviewing partner's conclusions that no matters came to his or her attention that would cause him or her to believe that: (a) the financial statements are not in conformity with generally accepted accounting principles in all material respects, or that the audit was not performed in accordance with generally accepted auditing standards; (b) material modifications should be made to the interim financial information for it to be in conformity with generally accepted accounting principles, or that the review was not performed in accordance with SAS No. 100; or (c) management's assertion about internal control is not fairly stated, in all material respects, based upon suitable criteria, or that the audit was not performed in accordance with generally accepted auditing standards.

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[6] As discussed in paragraph 14 of the proposed SAS, *Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit*, the auditor may issue a separate report on internal control or a combined report on the financial statements and internal control.

[7] In this instance, the reviewing partner ordinarily would concern himself or herself with matters relating to the subsequent events procedures.

Effective Date

13. This statement is effective for audits or reviews of SEC engagements for periods ending on or after September 15, 2003. Early application is permissible.

PROPOSED AMENDMENT
AU SECTION 310, *APPOINTMENT OF THE INDEPENDENT AUDITOR*

This proposed amendment revises AU sec. 310 to, among other things, require the auditor to document the understanding with the client through a written communication, expands on the matters to be included in the understanding with the client, and, for public company audits, requires the auditor to establish an understanding with the client regarding the audit of internal control in accordance with the proposed SAS, *Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit*. New material is shown in bold italics; deleted material is shown in strikethrough. The requirement in paragraph 6 to document the understanding through a written communication with the client is effective for audits of financial statements for periods beginning after December 15, 2003. The other provisions of this amendment are effective for audits of financial statements for periods ending on or after September 15, 2003. Early application is permissible.

1. The first standard of fieldwork is:
   The work is to be adequately planned and assistants, if any, are to be properly supervised.

2. Aspects of supervising assistants are discussed in AU sec. 210, *Training and Proficiency of the Independent Auditor* (AICPA, *Professional Standards,* vol. 1, AU sec. 210), and AU sec. 311, *Planning and Supervision* (AICPA, *Professional Standards,* vol. 1, AU sec. 311). Aspects of planning the fieldwork and the timing of auditing procedures are discussed in AU sec. 311 and AU sec. 313, *Substantive Tests Prior to the Balance-Sheet Date* (AICPA, *Professional Standards,* vol. 1, AU sec. 313).

Appointment of the Independent Auditor

3. For audits of entities subject to Section 10A of the Securities Exchange Act of 1934, the audit committee (or the board of directors if there is no audit committee) is directly responsible for the appointment, compensation, and oversight of the work of the auditor (including resolution of disagreements between management and the auditor regarding financial reporting), and the auditor reports directly to the audit committee. In addition, the audit committee is required to preapprove all audit and nonaudit services provided by the auditor. Therefore, for audits of such entities, the audit committee (or the entire board of directors if there is no audit committee) ordinarily engages the auditor on behalf of the entity and its shareholders or partners.

4. For audits of other entities, the auditor may be engaged by the audit committee, board of directors, shareholders, management, owner-manager, proprietor, general partner, or others as the circumstances dictate. In entities that have an audit committee or have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee (such as a finance committee or budget committee), the audit committee would normally engage the auditor.

5~~3~~. Consideration of the first standard of fieldwork recognizes that early appointment of the independent auditor has many advantages to both the auditor and ***the entity*** ~~his client~~. Early appointment enables the auditor to plan ***the*** ~~his~~ work so that it may be done expeditiously and to determine the extent to which it can be done before the balance-sheet date. (See AU sec. 313.)

Appointment of Auditor Near or After the Year-End Date

6~~4~~. Although early appointment is preferable, an independent auditor may accept an engagement near or after the close of the fiscal year. In such instances, before accepting the engagement, ***the auditor*** ~~he~~ should ascertain whether circumstances are likely to permit an adequate audit and expression of an unqualified opinion and, if they will not, ***the auditor*** ~~he~~ should discuss with the client the possible necessity for a qualified opinion or disclaimer of opinion. Sometimes the audit limitations present in such circumstances can be remedied. For example, the taking of the physical inventory can be postponed or another physical inventory can be taken which the auditor can observe. (See AU sec. 331.09-.13.)

Establishing an Understanding With the Client

7~~5~~. The auditor should establish an understanding with the client regarding the services to be performed for each engagement.[1] Such an understanding reduces the risk that either the auditor or the client may misinterpret the needs or expectations of the other party. For example, it reduces the risk that the client may inappropriately rely on the auditor to protect the entity against certain risks or to perform certain functions that are ~~the client's~~ ***management's*** responsibility. The understanding should include the objectives ***and limitations*** of the engagement, ***the auditor's responsibilities, and*** management's responsibilities***.*** ***[2]*** ~~the auditor's responsibilities, and limitations of the engagement~~.~~[2]~~ The auditor should document the understanding ~~in the working papers, preferably~~ through a written communication ***(sometimes referred to as an engagement letter)*** with the client***, preferably signed by both the auditor and the client***. If the auditor believes an understanding with the client has not been established, he or she should decline to accept or perform the engagement.

8~~6~~. An understanding with the client regarding an audit of the financial statements ***should*** include~~s~~ the following matters:

- The objective of ***an*** ~~the~~ audit ***of financial statements*** is ***to express*** ~~the expression of~~ an opinion on the financial statements.
- ~~Management is responsible for the entity's financial statements.~~
- ~~Management is responsible for establishing and maintaining effective internal control over financial reporting.~~
- ~~Management is responsible for identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.~~
- ~~Management is responsible for making all financial records and related information available to the auditor.~~
- ~~At the conclusion of the engagement, management will provide the auditor with a letter that confirms certain representations made during the audit.~~
- The auditor is responsible for conducting the audit in accordance with generally accepted auditing standards. Those standards require that the auditor obtain reasonable rather than absolute assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Accordingly, a material misstatement may remain undetected. Also, an audit is not designed to detect error or fraud that is immaterial to the financial statements. If, for any reason, the auditor is unable to complete the audit or is unable to form or has not formed an opinion, he or she may decline to express an opinion or decline to issue a report as a result of the engagement.

- An audit ***of financial statements*** includes obtaining an understanding of internal control sufficient to plan the audit and to determine the nature, timing, and extent of audit procedures to be performed. An audit ***of financial statements*** is not designed to provide assurance on internal control or to identify ***significant deficiencies*** ~~reportable conditions~~. However, the auditor is responsible for ensuring that the audit committee or others with equivalent authority or responsibility are aware of any ~~reportable conditions which~~ ***significant deficiencies that*** come to his or her attention.[3] ***(Not applicable to certain engagements; see paragraph 9.)***

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[1] See Statement on Quality Control Standards (SQCS) No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (AICPA, *Professional Standards,* vol. 1, QC sec. 20.16).

[2] The objective of certain engagements may differ. The understanding should reflect the effects of those objectives on the responsibilities of management and the auditor, and on the limitations of the engagement. The following are examples:

- Reviews of interim financial information. See AU sec. 722, *Interim Financial Information*, (AICPA, *Professional Standards,* vol. 1, AU sec. 722.09.
- Audits of recipients of governmental financial assistance. See AU sec. 801, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards,* vol. 1, AU sec. 801.10).
- Application of agreed-upon procedures to specified elements, accounts, or items of a financial statement. See AT section 201, *Agreed –Upon Procedures Engagements* (AICPA, *Professional Standards,* vol. 1, AU sec. 201).

[3] See AU sec. 325, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards,* vol. 1, AU sec. 325).

- ***The auditor is also responsible to determine that certain other matters related to the conduct of the audit are communicated to the audit committee, including (a) fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements,[4] (b) illegal acts that come to his or her attention (unless they are clearly inconsequential),[5] (c) disagreements with management and other serious difficulties encountered in performing the audit, and (d) various matters related to the entity's accounting policies and financial statements.[6]***
- ***Management is responsible for the entity's financial statements.***
- ***Management is responsible for establishing and maintaining effective internal control over financial reporting, and for informing the auditor of all significant deficiencies in the design or operation of such controls of which it has knowledge.***
- ***Management is responsible for identifying and ensuring that the entity complies with the laws and regulations applicable to its activities, and for informing the auditor of any known material violations of such laws or regulations.***
- ***Management is responsible for the design and implementation of programs and controls to prevent and detect fraud, and for informing the auditor about all known or suspected fraud affecting the entity involving (a) management, (b) employees who have significant roles in internal control, and (c) others where the fraud could have a material effect on the financial statements. Management is also responsible for informing the auditor of its knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, analysts, regulators, short sellers, or others.***
- ***Management is responsible for making all financial records and related information available to the auditor.***
- ***At the conclusion of the engagement, management will provide the auditor with a letter that confirms certain representations made during the audit.***
- Management is responsible for adjusting the financial statements to correct material misstatements and for affirming to the auditor in the representation letter that the effects of any uncorrected misstatements[7] aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

~~These matters may be communicated in the form of an engagement letter.~~

9. If applicable,[8] the auditor should also establish an understanding with the client regarding the audit of internal control over financial reporting in accordance with the proposed SAS,* Auditing an Entity's Internal Control Over Financial Reporting in Conjunction with the Financial Statement Audit*. The understanding should include the following matters:

- ***The auditor's objective is to express an opinion about whether management's written assertion about the effectiveness of internal control over financial reporting, taken as a whole, is fairly stated, in all material respects, based on the control criteria.***
- ***The auditor is responsible for conducting the engagement to obtain reasonable rather than absolute assurance that the auditor's procedures would detect a material weakness in internal control. Accordingly, material weaknesses may exist and not be detected. Also, an audit of***

[4] See AU sec. 316,* Consideration of Fraud in a Financial Statement Audit *(AICPA,* Professional Standards, *vol. 1, AU sec. 316).

[5] See AU sec. 317,* Illegal Acts by Clients *(AICPA,* Professional Standards, *vol. 1, AU sec. 317).

[6] See AU sec. 380,* Communication With Audit Committees *(AICPA,* Professional Standards, *vol. 1, AU sec. 380).

[7] AU sec. 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards,* vol. 1, AU sec. 312.04), states that a misstatement can result from errors or fraud.

[8] This provision is applicable to audits of financial statements included in annual reports of entities, other than registered investment companies, that file with the Securities and Exchange Commission (SEC) pursuant to Section 13 (a) or 15 (d) of the Securities Exchange Act of 1934, in which the auditor is engaged to perform the audit of the entity's financial statements also is required to audit the entity's internal control over financial reporting.

internal control is not designed to detect internal control deficiencies of a lesser magnitude than material weaknesses, including significant deficiencies.

- ***The auditor is responsible for reporting to the audit committee material weaknesses that have been identified. In addition, the auditor will determine that the audit committee is aware of significant deficiencies that have been identified.***
- ***The auditor is responsible for conducting the audit of internal control in accordance with generally accepted auditing standards. Those standards require the auditor to obtain an understanding of internal control over financial reporting, and test and evaluate the design and operating effectiveness of internal control.***
- ***Management is responsible for evaluating the effectiveness of the entity's internal control using suitable control criteria.***
- ***Management is responsible for presenting a written assertion about the effectiveness of its internal control and for disclosing all significant deficiencies and material weaknesses in internal control in its assertion.***
- ***Management is responsible for supporting its evaluation with sufficient evidence. The absence of sufficient evidence to support management's evaluation of the operating effectiveness of internal control constitutes a material weakness in internal control.***
- ***At the conclusion of the engagement, management will provide the auditor with a letter that confirms certain representations made during the audit of internal control, and disclosing whether, subsequent to the date of the assertion, there were any changes in internal control or other factors that might significantly affect internal control, including any corrective actions taken by management with regard to the identified significant deficiencies and material weaknesses.***

10~~7~~. An understanding with the client also may include other matters, such as the following:

- ***The audit committee's responsibility for informing the auditor of its views about the risks of fraud within the entity, and its knowledge of any fraud or suspected fraud affecting the entity***
- Arrangements regarding the conduct of the engagement (for example, timing, ~~client~~ ***management*** assistance regarding the preparation of schedules, and the availability of documents)
- Arrangements concerning involvement of specialists or internal auditors, if applicable
- Arrangements involving a predecessor auditor
- Arrangements regarding fees and billing
- Any limitation of or other arrangements regarding the liability of the auditor or the ~~client~~***entity***, such as indemnification to the auditor for liability arising from knowing misrepresentations to the auditor by management (Regulators, including the SEC, may restrict or prohibit such liability limitation arrangements.)
- Conditions under which access to the ***audit documentation*** ~~auditor's working papers~~ may be granted to others
- Additional services to be provided relating to regulatory requirements
- Arrangements regarding other services to be provided in connection with the engagement

PROPOSED AMENDMENT
AU SECTION 315, *COMMUNICATION BETWEEN PREDECESSOR AND SUCCESSOR AUDITORS*

This proposed amendment revises paragraph 21 of AU sec. 315, *Communication Between Predecessor and Successor Auditors* (AICPA, *Professional Standards,* vol. 1, AU sec. 315), and adds new footnotes 10 and 11. New material is shown in bold italics; deleted material is shown in strikethrough. This amendment is effective upon issuance.

Discovery of Possible Misstatements in Financial Statements Reported on by a Predecessor Auditor

.21 If during the audit or reaudit, the successor auditor becomes aware of information that leads him or her to believe that financial statements reported on by the predecessor auditor may require revision, the successor auditor should request that the client inform the predecessor auditor of the situation and arrange for the three parties to discuss this information and attempt to resolve the matter. The successor auditor should communicate to the predecessor auditor any information that the predecessor auditor may need to consider in accordance with AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (AICPA, *Professional Standards,* vol. 1, AU sec. 561), which sets out the procedures that an auditor should follow when ~~the auditor~~ ***he or she*** subsequently discovers facts that may have affected the audited financial statements previously reported on.[9] ***The successor auditor should not report on revised financial statements***[10] ***prior to communicating to the predecessor auditor the information set forth above.***[11]

[9] See AU sec. 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards,* vol. 1, AU secs. 508.70-.74), for reporting guidance.

[10] ***When the prior-period financial statements have been revised, the successor auditor may be engaged either to reaudit the prior period financial statements (see AU sec. 315.14-.20) or to audit only the restatement adjustments (see AU sec. 508.74).***

[11] ***In situations where the predecessor auditor has ceased operations, this discussion should include the party responsible for winding up the affairs of the predecessor firm.***

PROPOSED AMENDMENT
AU SECTION 316, *CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT*

This proposed amendment revises AU sec. 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards,* vol. 1, AU sec. 316), to include a new paragraph 23 and renumber all subsequent paragraphs. New material is shown in bold italics. This amendment is effective for audits of financial statements ending on or after the date that the procedures described in paragraph 23 have been established.

22. The auditor also should inquire directly of the audit committee (or at least its chair) regarding the audit committee's views about the risks of fraud and whether the audit committee has knowledge of any fraud or suspected fraud affecting the entity. An entity's audit committee sometimes assumes an active role in oversight of the entity's assessment of the risks of fraud and the programs and controls the entity has established to mitigate these risks. The auditor should obtain an understanding of how the audit committee exercises oversight activities in that area.

23. Section 10A of the Securities Exchange Act of 1934 requires each audit committee to establish procedures for (a) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and (b) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters. For entities subject to these requirements, the auditor should inquire as to the procedures placed in operation, and complaints received or concerns expressed under the procedures established by the audit committee as a result of these requirements.

PROPOSED AMENDMENT
AU SECTION 333, *MANAGEMENT REPRESENTATIONS*

This proposed amendment revises paragraph 6 of AU sec. 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), to add new representations relating to internal control; it also adds the new representations to the Illustrative Management Representation Letter in Appendix A. New material is shown in bold italics; deleted material is shown in strikethrough. This amendment is effective for audits of financial statements for periods ending on or after September 15, 2003. Early application is permissible.

.06 In connection with an audit of financial statements presented in accordance with generally accepted accounting principles, specific representations should relate to the following matters[3]

Financial Statements

a. Management's acknowledgment of its responsibility for the fair presentation in the financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles

b. Management's belief that the financial statements are fairly presented in conformity with generally accepted accounting principles

Internal Control

c. ***Disclosure of all significant deficiencies, including material weaknesses, in the design or operation of internal controls that could adversely affect the entity's ability to record, process, summarize, and report financial data. In a public company audit (see the proposed SAS,*** **Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit*****), the auditor may wish to obtain a combined representation letter for both the audit of the financial statements and the audit of internal control. Representations related to the audit of internal control should include those contained in AT sec. 501,*** **Reporting on an Entity's Internal Control Over Financial Reporting** ***(AICPA,*** **Professional Standards,** ***vol. 1, AT sec. 501.44)***

d. ***Management's acknowledgment of its responsibility for the design and implementation of programs and controls to prevent and detect fraud***

e. ***Knowledge of fraud or suspected fraud affecting the entity involving (1) management, (2) employees who have significant roles in internal control, or (3) others where the fraud could have a material effect on the financial statements***

f. ***Knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, analysts, regulators, short sellers, or others***

Completeness of Information

g. Availability of all financial records and related data

h. Completeness and availability of all minutes of meetings of stockholders, directors, and committees of directors ~~Management's acknowledgment of its responsibility for the design and implementation of programs and controls to prevent and detect fraud~~

i. Communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices ~~Knowledge of fraud or suspected fraud affecting the entity involving (1) management, (2) employees who have significant roles in internal control, or (3) others where the fraud could have a material effect on the financial statements~~

[3] Specific representations also are applicable to financial statements presented in conformity with a comprehensive basis of accounting other than generally accepted accounting principles (GAAP). The specific representations to be obtained should be based on the nature and basis of presentation of the financial statements being audited.

j. Absence of unrecorded transactions ~~Knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, analysts, regulators, short sellers, or others~~

Recognition, Measurement, and Disclosure

k. Management's belief that the effects of any uncorrected financial statement misstatements[4] aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole[5] (A summary of such items should be included in or attached to the letter.) [6, 7]

l. Plans or intentions that may affect the carrying value or classification of assets or liabilities

m. Information concerning related-party transactions and amounts receivable from or payable to related parties[8]

n. Guarantees, whether written or oral, under which the entity is contingently liable

o. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the AICPA's Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*

p. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency[9]

q. Unasserted claims or assessments that the entity's lawyer has advised are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (AC section C59)[10]

r. Other liabilities and gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5 (AC section C59)[11]

s. Satisfactory title to assets, liens or encumbrances on assets, and assets pledged as collateral

t. Compliance with aspects of contractual agreements that may affect the financial statements

Subsequent Events

u. Information concerning subsequent events[12]

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[4] AU sec. 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards,* vol. 1, AU sec. 312.04), states that a misstatement can result from errors or fraud, and provides guidance for the auditor's evaluation of audit findings (AU sec. 312.34-.40).

[5] If management believes that certain of the identified items are not misstatements, management's belief may be acknowledged by adding to the representation, for example, "We do not agree that items XX and XX constitute misstatements because [*description of reasons*]."

[6] AU sec. 312 states that the auditor may designate an amount below which misstatements need not be accumulated. Similarly, the summary of uncorrected misstatements included in or attached to the representation letter need not include such misstatements. The summary should include sufficient information to provide management with an understanding of the nature, amount, and effect of the uncorrected misstatements. Similar items may be aggregated.

[7] The communication to management of immaterial misstatements aggregated by the auditor does not constitute a communication pursuant to AU sec. 317, *Illegal Acts by Clients* (AICPA, *Professional Standards,* vol. 1, AU sec. 317.17, Section 10A of the Securities Exchange Act of 1934, or AU sec. 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards,* vol. 1, AU sec. 316.38-.40). The auditor may have additional communication responsibilities pursuant to AU sec. 317, Section 10A of the Securities Exchange Act of 1934, or AU sec. 316.

[8] See AU sec. 334.

[9] See AU sec. 317.

[10] See AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards,* vol. 1, AU 337.05*d)*. If the entity has not consulted a lawyer regarding litigation, claims, and assessments, the auditor normally would rely on the review of internally available information and obtain a written representation by management regarding the lack of litigation, claims, and assessments; see auditing Interpretation No. 6, "Client Has Not Consulted a Lawyer" (section 9337.15—.17).

[11] See AU sec. 337.0*5b*.

[12] See AU sec. 560, *Subsequent Events* (AICPA, *Professional Standards,* vol. 1, AU sec. 560.12); AU sec. 711, *Filings Under Federal Securities Statutes* (AICPA, *Professional Standards,* vol. 1, AU sec. 711.10); and AU sec. 634,

.07 The representation letter ordinarily should be tailored to include additional appropriate representations from management relating to matters specific to the entity's business or industry.[13] Examples of additional representations that may be appropriate are provided in Appendix B, "Additional Illustrative Representations" (AU sec. 333.17).

.08 Management's representations may be limited to matters that are considered either individually or collectively material to the financial statements, provided management and the auditor have reached an understanding on materiality for this purpose. Materiality may be different for different representations. A discussion of materiality may be included explicitly in the representation letter, in either qualitative or quantitative terms. Materiality considerations would not apply to those representations that are not directly related to amounts included in the financial statements, for example, items (*a*), ***(b),*** (*c*), (*d*), ***(*g*), (*h*),*** and ***(*i*)*** ~~(e)~~ ***in paragraph 6***~~above~~. In addition, because of the possible effects of fraud on other aspects of the audit, materiality would not apply to item ~~(h)~~ ***(e)*** above with respect to management or those employees who have significant roles in internal control ***or to item (f)***.

.16

Appendix A
Illustrative Management Representation Letter

1. The following letter, which relates to an audit of financial statements prepared in conformity with generally accepted accounting principles, is presented for illustrative purposes only. The introductory paragraph should specify the financial statements and periods covered by the auditor's report, for example, "balance sheets of XYZ Company as of December 31, ~~19~~***20***X1 and ~~19~~***20***X0, and the related statements of income and retained earnings and cash flows for the years then ended." The written representations to be obtained should be based on the circumstances of the engagement and the nature and basis of presentation of the financial statements being audited. See Appendix B (AU sec. 333.17).

2. If matters exist that should be disclosed to the auditor, they should be indicated by ~~listing them~~ ***modifying*** ~~following~~the ***related*** representation. For example, if an event subsequent to the date of the balance sheet has been disclosed in the financial statements, the final paragraph could be modified as follows: "To the best of our knowledge and belief, except as discussed in Note X to the financial statements, no events have occurred. . . ." ~~Similarly, i~~***I***n appropriate circumstances, item ~~7~~***9*** could be modified as follows: "The ***entity***~~company~~ has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities, except for its plans to dispose of segment A, as disclosed in Note X to the financial statements, which are discussed in the minutes of the December 7, 20X1, meeting of the board of directors." Similarly, if management has received a communication regarding an allegation of fraud or suspected fraud, item ~~8~~***9*** could be modified as follows: "Except for the allegation discussed in the minutes of the December 7, 20X1, meeting of the board of directors (or disclosed to you on October 15, 20X1), we have no knowledge of any allegations of fraud affecting the ***entity***~~company~~ received in communications from employees, former employees, analysts, regulators, short sellers, or others."

3. The qualitative discussion of materiality used in the illustrative letter is adapted from FASB Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*.

4. Certain terms are used in the illustrative letter that are described elsewhere in authoritative literature. Examples are fraud, in AU sec. 316, and related parties, in AU sec. 334, footnote 1. To avoid

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Letters for Underwriters and Certain Other Requesting Parties (AICPA, *Professional Standards,* vol. 1, AU sec. 634.45, footnote 29).

[13] Certain AICPA Audit Guides recommend that the auditor obtain written representations concerning matters that are unique to a particular industry.

misunderstanding concerning the meaning of such terms, the auditor may wish to furnish those definitions to management or request that the definitions be included in the written representations.

5. The illustrative letter assumes that management and the auditor have reached an understanding on the limits of materiality for purposes of the written representations. However, it should be noted that a materiality limit would not apply for certain representations, as explained in paragraph .08 of this section.

6.

[*Date*]
To [*Independent Auditor*]

We are providing this letter in connection with your audit(s) of the [*identification of financial statements*] of [*name of entity*] as of [*dates*] and for the [*periods*] for the purpose of expressing an opinion as to whether the [*consolidated*] financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of [*name of entity*] in conformity with accounting principles generally accepted in the United States of America. We confirm that we are responsible for the fair presentation in the [*consolidated*] financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, [*as of* (*date of auditor's report),*] *the following representations made to you during your audit*(*s*).

1. The financial statements referred to above are fairly presented in conformity with accounting principles generally accepted in the United States of America.
2. We have made available to you all:
   a. Financial records and related data.
   b. Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.
3. There have been no communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.
4. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
5. We believe that the effects of the uncorrected financial statement misstatements summarized in the accompanying schedule are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. [footnote omitted]
6. ***There are no significant deficiencies, including material weaknesses, in the design or operation of internal controls that could adversely affect the entity's ability to record, process, summarize, and report financial data.***[18]
7. We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.
8. We have no knowledge of fraud or suspected fraud affecting the entity involving:
   a. Management,
   b. Employees who have significant roles in internal control, or
   c. Others where the fraud could have a material effect on the financial statements.

[18] ***In a public company audit (see the proposed SAS,* Auditing an Entity's Internal Control over Financial Reporting in Conjunction with the Financial Statement Audit*, the auditor may wish to obtain a combined representation letter for both the audit of the financial statements and the audit of internal control. Representations related to the audit of internal control should include those contained in AT section 501.44.***

9. We have no knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, analysts, regulators, short sellers, or others.
10. The ~~company~~ ***entity*** has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
11. The following have been properly recorded or disclosed in the financial statements:
    a. Related-party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.
    b. Guarantees, whether written or oral, under which the company is contingently liable.
    c. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the AICPA's Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (Significant estimates are estimates at the balance sheet date that could change materially within the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.)
12. There are no:
    a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency
    b. Unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*
    c. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5
13. The ~~company~~ ***entity*** has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral.
14. The ~~company~~ ***entity*** has complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

[*Add additional representations that are unique to the entity's business or industry. See AU sec. 333.07 and Appendix B, "Additional Illustrative Representations," (AU sec. 333.17] of this section.*)

To the best of our knowledge and belief, no events have occurred subsequent to the balance-sheet date and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.

____
[*Name of Chief Executive Officer and Title*]

____
[*Name of Chief Financial Officer and Title*]

PROPOSED AMENDMENT
AU SECTION 334, *RELATED* PARTIES

This amendment revises paragraph 9 to add new footnote 6 and to renumber subsequent footnotes in AU sec. 334, *Related Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 334). New material is shown in bold italics; deleted material is shown in strikethrough. This amendment is effective upon issuance.

Examining Identified Related Party Transactions
.09 After identifying related party transactions, the auditor should apply the procedures he considers necessary to obtain satisfaction concerning the purpose, nature, and extent of these transactions***[6]*** and their effect on the financial statements. The procedures should be directed toward obtaining and evaluating sufficient competent evidential matter and should extend beyond inquiry of management. Procedures that should be considered include the following:

a. Obtain an understanding of the business purpose of the transaction.[7]
b. Examine invoices, executed copies of agreements, contracts, and other pertinent documents, such as receiving reports and shipping documents.
c. Determine whether the transaction has been approved by the board of directors or other appropriate officials.
d. Test for reasonableness the compilation of amounts to be disclosed, or considered for disclosure, in the financial statements.
e. Arrange for the audits of intercompany account balances to be performed as of concurrent dates, even if the fiscal years differ, and for the examination of specified, important, and representative related-party transactions by the auditors for each of the parties, with appropriate exchange of relevant information.
f. Inspect or confirm and obtain satisfaction concerning the transferability and value of collateral.

[6] ***Related-party transactions may represent possible illegal acts. For example, certain loans to a director or an executive officer of a public company may be prohibited by the Securities Exchange Act of 1934. Statement on Auditing Standards (SAS) No. 54,* Illegal Acts by Clients *(AICPA,* Professional Standards*, vol. 1, AU sec. 317.10-11), provides guidance on the auditor's response when the auditor becomes aware of information concerning a possible illegal act.***
[7] Until the auditor understands the business sense of the transactions, he cannot complete his audit. If he lacks sufficient specialized knowledge to understand a particular transaction, he should consult with persons who do have the requisite knowledge.

PROPOSED AMENDMENT
AU SECTION 339, *AUDIT DOCUMENTATION*

This proposed amendment revises paragraph 10 of, and adds new paragraph 14 to, AU sec. 339, *Audit Documentation* (AICPA, *Professional Standards,* vol. 1, AU sec. 339.10). New material is shown in bold italics; deleted material is shown in strikethrough. This amendment is effective for audits of financial statements completed on or after October 31, 2003. Early application is permissible.

It also adds new item *q* to the appendix to include the new documentation requirements of AU sec. 722, *Interim Financial Information* (AICPA, *Professional Standards,* vol. 1, AU sec. 722).

Ownership and Confidentiality of Audit Documentation

.10 Audit documentation is the property of the auditor, and some states recognize this right of ownership in their statutes. ~~The auditor should adopt reasonable procedures to retain audit documentation for a period of time sufficient to meet the needs of his or her practice and to satisfy any applicable legal or regulatory requirements for records retention.~~[7]

.11 The auditor has an ethical, and in some situations a legal, obligation to maintain the confidentiality of client information.[8] Because audit documentation often contains confidential client information, the auditor should adopt reasonable procedures to maintain the confidentiality of that information.

.12 The auditor also should adopt reasonable procedures to prevent unauthorized access to the audit documentation.

.13 Certain audit documentation may sometimes serve as a useful reference source for the client, but it should not be regarded as a part of, or a substitute for, the client's accounting records.

Retention of Audit Documentation

14. The auditor should adopt reasonable procedures to retain audit documentation for a period of seven years after the auditor concludes the audit and for such additional period of time sufficient to satisfy any applicable legal or regulatory requirements for records retention.[9,10]

Appendix A
Audit Documentation Requirements in Other Statements on Auditing Standards

.16~~.15~~

1. Documentation requirements are included in other Statements on Auditing Standards. This section does not change the requirement in:

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[7] ~~The procedures should enable the auditor to access electronic audit documentation throughout the retention period.~~
[8] Also see Rule 301, *Confidential Client Information* (AICPA, *Professional Standards,* vol. 2, ET sec. 301.01), of the AICPA's *Code of Professional Conduct*.
[9] ***The procedures should enable the auditor to access electronic audit documentation throughout the retention period.***
[10] ***For Securities and Exchange Commission (SEC) engagements, auditors are also required by SEC Rule 2-06 of Regulation S-X to retain certain other records relevant to the audit for a period of seven years from completion of the audit.***

a. AU sec. 310, *Establishing an Understanding With the Client* (AU sec. 310.05), to document the understanding with the client.

b. AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AU sec. 337.05d), to document in either the audit inquiry letter or a separate letter to the client's lawyer, that the client has assured the auditor that it has disclosed all unasserted claims that the lawyer has advised the client are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*. Also, this section does not change the requirement in section 337.10 to document the conclusions reached as a result of responses obtained in a conference relating to matters covered by the audit inquiry letter.

c. AU sec. 311, *Planning and Supervision* (AU sec. 311.05), to prepare a written audit program (or set of written audit programs) for every audit.

d. AU sec. 312, *Audit Risk and Materiality in Conducting an Audit* (AU sec. 312.40), to document the nature and effect of aggregated misstatements and the auditor's conclusion as to whether the aggregated misstatements cause the financial statements to be materially misstated.

e. AU sec. 534, *Reporting on Financial Statements Prepared for Use in Other Countries* (AU sec. 534.02), to obtain written representations from management regarding the purpose and uses of financial statements prepared in conformity with the accounting principles of another country.

f. AU sec. 317, *Illegal Acts by Clients* (AU sec. 317.17), to document oral communications to the audit committee or others with equivalent authority and responsibility regarding illegal acts that come to the auditor's attention.

g. AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit* (AU sec. 319.61), to document the understanding of the entity's internal control components obtained to plan the audit. Also, this section does not change the requirement in AU sec. 319.83 for the auditor to document his or her conclusions about the assessed level of control risk.

h. AU sec. 329, *Analytical Procedures* (AU sec. 329.22), to document (1) the expectation, where that expectation is not otherwise readily determinable from the documentation of the work performed, and factors considered in its development; (2) the results of the comparison of the expectation to the recorded amounts or ratios developed from recorded amounts; and (3) any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures.

i. AU sec. 508, *Reports on Audited Financial Statements* (AU sec. 508.71), for the predecessor auditor to obtain representation letters from management of the former client and from the successor auditor before reissuing (or consenting to the reissue of) a report previously issued on the financial statements of a prior period.

j. AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU sec. 341.17), to document (1) the conditions or events that led him or her to believe that there is substantial doubt about the entity's ability to continue as a going concern; (2) the work performed in connection with the auditor's evaluation of management's plans; (3) the auditor's conclusion as to whether substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains or is alleviated; and (4) the consideration and effect of that conclusion on the financial statements, disclosures, and the audit report.

k. AU sec. 325, *Communication of Internal Control Related Matters Noted in an Audit* (AU sec. 325.09), to document oral communications with the audit committee or others with equivalent authority and responsibility of conditions noted by the auditor that are considered reportable or that are the result of agreement with the client.

l. AU sec. 380, *Communication With Audit Committees* (AU sec. 380.03), to document any oral communications with the audit committee, made pursuant to the SAS, regarding the scope and results of the audit.

m. AU sec. 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 330.29), to document oral confirmations. Also, when the auditor has not requested confirmations in the examination of accounts receivable, this section does not change the requirement in AU sec. 330.35 to document how the auditor overcame this presumption.

n. AU sec. 801, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AU sec. 801.23), to document the oral communications to management and the audit committee or others with equivalent authority and responsibility when the auditor becomes aware during an audit in accordance with generally accepted auditing standards that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement.

o. AU sec. 316, *Consideration of Fraud in a Financial Statement Audit* (AU sec. 316.37), to include in audit documentation evidence of the performance of the assessment of the risk of material misstatement due to fraud and the auditor's response to risk factors identified. Also, this section does not change the requirement to document any fraud risk factors or other conditions identified during the audit and any further response that the auditor concluded was appropriate.

p. AU sec. 333, *Management Representations*, to obtain written representations from management.

q. ***AU sec. XXX,* Review of SEC Engagements by a Reviewing Partner*, to demonstrate that the required review procedures have been performed and include, as applicable, the reviewing partner's conclusions that no matters came to his or her attention that would cause him or her to believe that: (1) the financial statements are not in conformity with generally accepted accounting principles in all material respects, or that the audit was not performed in accordance with generally accepted auditing standards; (2) material modifications should be made to the interim financial information for it to be in conformity with generally accepted accounting principles, or that the review was not performed in accordance with SAS No. 100; or (3) management's assertion about internal control is not fairly stated, in all material respects, based upon suitable criteria, or that the audit was not performed in accordance with generally accepted auditing standards.***

r. **AU *Section 722,* Interim Financial Information (AU sec. *722.53), to adopt reasonable procedures to retain review documentation for a period of seven years after the accountant concludes the audit of financial statements of the fiscal year including the period under review or, if no such audit report is issued, from completion of the review procedures for the last interim period reviewed within that fiscal year and for such additional period of time sufficient to satisfy any applicable legal or regulatory requirements for record retention.***

PROPOSED AMENDMENT
AU SECTION 380, *COMMUNICATION WITH AUDIT COMMITTEES*

This proposed amendment revises AU sec. 380, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380) to among other things, define an audit committee and include specific audit requirements for SEC engagements. New material is shown in bold italics; deleted material is shown in strikethrough. This amendment is effective upon issuance, with the exception of paragraph 21 for non-SEC engagements, which is effective for audits of financial statements for periods ending after December 15, 2003. Early application is permissible.

Introduction

1. This Statement establishes a requirement for the auditor to determine that certain matters related to the conduct of an audit are communicated to those who have responsibility for oversight of the financial reporting process.[1] For purposes of this Statement, the recipient of the communications is referred to as the *audit committee****. An audit committee is (a) a committee (or equivalent body, such as a finance committee or a budget committee) established by and among the board of directors or other governing body for the purpose of overseeing the accounting and financial reporting processes of the entity and audits of the financial statements of the entity; or (b) for Securities and Exchange Commission (SEC)[2] engagements, if no such committee exists, the entire board of directors. In some SEC engagements, the entity may not have either an audit committee or a board of directors (e.g. a limited partnership). In such cases, the auditor should consider the individual general***

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[1] Communication with the audit committee by the independent auditor on certain specified matters when they arise in the conduct of an audit is required by other standards, including: –

- AU sec. 325, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards,* vol. 1, AU sec. 325)
- AU sec. 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards,* vol. 1, AU sec. 316)
- AU sec. 317, *Illegal Acts* (AICPA, *Professional Standards,* vol. 1, AU sec. 317)
- AU sec. 801, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards,* vol. 1, AU sec. 801)

In addition, AU sec. 722, *Interim Financial Information* (AICPA, *Professional Standards,* vol. 1, AU sec. 722), requires that certain information be communicated to audit committees as a result of performing a review of interim financial information~~ or assisting an entity in preparing such information~~.

[2] For purposes of this section, an SEC engagement is defined as one that involves the audit of the financial statements of:

1. An ***entity*** ~~issuer~~ making an initial filing, including amendments, under the Securities Act of 1933 (the 1933 Act) and the Securities Exchange Act of 1934 (the 1934 Act).
2. A registrant that files periodic reports ***(for example, Forms N-SAR, 10-K, 10-KSB, or 11-K)*** with the SEC under the Investment Company Act of 1940 or the 1934 Act (except a broker or dealer registered only because of section 15(a) of the 1934 Act). ***(Rules 12g-4 and 12h-3 under the 1934 Act provide an exemption from periodic reporting to the SEC to [1] entities with less than $10 million in total assets on the last day of each of the entity's three most recent fiscal years and fewer than 500 shareholders and [2] entities with fewer than 300 shareholders. Accordingly, such entities are not encompassed within the scope of this definition.)***
3. A bank or other lending institution that files periodic reports with the Comptroller of the Currency, the Federal Reserve Board (FRB) system, the Federal Deposit Insurance Corporation (FDIC), or the ***Office of Thrift Supervision (OTS)***~~Federal Home Loan Board~~ because the powers, functions and duties of the SEC to enforce its periodic reporting provisions are vested, pursuant to section 12(i) of the 1934 Act, in those agencies. (***Rules 12-g-4 and 12 h-3 under*** the 1934 Act provides an exemption from periodic reporting to the SEC to (1) entities with less than $***10***~~5~~ million in total assets on the last day of each of the entity's three most recent fiscal years and fewer than 500 shareholders and (2) entities with fewer than 300 shareholders. Accordingly, such entities are not encompassed within the scope of this definition.)
4. ~~A company whose financial statements appear in the annual report or proxy statement of any investment fund because it is a sponsor or manager of such a fund, but which is not itself a registrant required to file periodic reports under the *Investment Act of* 1940 or section 13 or 15(d) of the Securities Exchange Act of 1934.~~

partner(s), the audit committee, or board of directors of the corporate general partner, or others with equivalent responsibility as fulfilling the role of the audit committee.

2. The communications required by this Statement are applicable to (1) entities that ~~either~~ have an audit committee***,*** ~~or that have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee (such as a finance committee or budget committee)~~ and (2) all ~~Securities and Exchange Commission (~~SEC~~)~~ engagements.[2] ***For all other entities, the auditor should consider informing the client of the matters covered by this Statement.***

3~~2~~. This Statement requires the auditor to ensure that the audit committee receives additional information regarding the scope and results of the audit that may assist the audit committee in overseeing the financial reporting and disclosure process for which management is responsible. This Statement does not require communications with management; however, it does not *preclude* communications with management or other individuals within the entity who may, in the auditor's judgment, benefit from the communications. ***Finally, this Statement is not intended to restrict the communication of other matters.***

~~3. The communications may be oral or written. If information is communicated orally, the auditor should document the communication by appropriate memoranda or notations in the working papers.~~[3] ~~When the auditor communicates in writing, the report should indicate that it is intended solely for the information and use of the audit committee or the board of directors and, if appropriate, management, and is not intended to be and should not be used by anyone other than these specified parties.~~

~~4. The communications specified by this Statement are incidental to the audit. Accordingly, they are not required to occur before the issuance of the auditor's report on the entity's financial statements, so long as the communications occur on a timely basis. There may be occasions, however, when discussion of certain of the matters (specified by paragraphs .06 through .14) below) with the audit committee prior to the issuance of the report may, in the auditor's judgment, be desirable.~~

~~5. It may be appropriate for management to communicate to the audit committee certain of the matters specified in this section. In such circumstances, the auditor should be satisfied that such communications have, in fact, occurred. Generally, it is not necessary to repeat the communication of recurring matters each year. Periodically, however, the auditor should consider whether, because of changes in the audit committee or simply because of the passage of time, it is appropriate and timely to report such matters.~~

Matters to Be Communicated

The Auditor's Responsibility Under Generally Accepted Auditing Standards

4~~6~~. An audit performed in accordance with generally accepted auditing standards may address many matters of interest to an audit committee. ~~For example, an audit committee is usually interested in internal control and in whether the financial statements are free of material misstatement.~~ In order for the audit committee to understand the nature of the assurance provided by an audit, the auditor should communicate the level of responsibility assumed for these matters under generally accepted auditing standards. It is also important for the audit committee to understand that an audit conducted in accordance with generally accepted auditing standards is designed to obtain reasonable, rather than absolute, assurance about the financial statements.

[3] ~~The auditor may wish to review the minutes, if any, prepared by the audit committee for consistency with the auditor's understanding of the communications.~~

~~**Significant Accounting Policies**~~

~~7. The auditor should determine that the audit committee is informed about the initial selection of and changes in significant accounting policies or their application. The auditor should also determine that the audit committee is informed about the methods used to account for significant unusual transactions and the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus. For example, significant accounting issues may exist in areas such as revenue recognition, off-balance-sheet financing, and accounting for equity investments.~~

Management Judgments and Accounting Estimates

5~~8~~. Accounting estimates are an integral part of the financial statements prepared by management and are based upon management's current judgments. Those judgments are normally based on knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management's current judgments. The auditor should determine that the audit committee is informed about the process used by management in formulating particularly sensitive accounting estimates and about the basis for the auditor's conclusions regarding the reasonableness of those estimates.

Audit Adjustments

6~~9~~. The auditor should ***report to*** ~~inform~~ the audit committee ~~about~~ adjustments arising from the audit that could, in his judgment, either individually or in the aggregate, have a significant effect on the entity's financial reporting process. For purposes of this section, an audit adjustment, whether or not recorded by the entity, is a proposed correction of the financial statements that, in the auditor's judgment, may not have been detected except through the auditing procedures performed. Matters underlying adjustments proposed by the auditor but not recorded by the entity could potentially cause future financial statements to be materially misstated, even though the auditor has concluded that the adjustments are not material to the current financial statements.

Uncorrected Misstatements

7~~10~~. The auditor ~~also~~ should ***report to*** ~~inform~~ the audit committee[4] ~~about~~ uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole.[5]

Accounting Policies and Alternative Treatments

8. The auditor should determine that the audit committee is informed about the initial selection of and changes in significant accounting policies or their application occurring during the current audit period. For changes in significant accounting policies or their application, the auditor should determine that the audit committee is informed of the reasons for the change.

9. The auditor should also determine that the audit committee is informed about the methods used to account for significant unusual transactions and the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.

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[4] The presentation to the audit committee should be similar to the summary of uncorrected misstatements included in or attached to the management representation letter. See footnote 6 of AU sec. 333, *Management Representations* (AICPA, *Professional Standards,* vol. 1, AU sec. 333).

[5] The communication to management and the audit committee of immaterial misstatements aggregated by the auditor does not constitute a communication pursuant to AU sec. 317.17, Section 10A of the Securities Exchange Act of 1934, or AU sec. 316.38-.40. The auditor may have additional communication responsibilities pursuant to AU sec. 317, Section 10A of the Exchange Act, or AU sec. 316.

10. In connection with an SEC engagement, the auditor should also:

a. Report to the audit committee all of the entity's critical accounting policies and practices applied in its financial statements and the auditor's assessment of management's disclosures regarding such policies and practices,[6] the reasons why certain policies and practices are or are not considered critical, and how current and anticipated future events impact those determinations. See paragraph 11.

b. Report to the audit committee all alternative treatments within generally accepted accounting principles[7] for accounting policies and practices related to material items[8], including recognition, measurement, presentation and disclosure alternatives, that have been discussed with management during the current audit period, the ramifications of the use of such alternative disclosures and treatments[9], and the treatment preferred by the auditor (see paragraph 12); and if an accounting policy selected by the client is not the policy preferred by the auditor, the auditor should inform the audit committee of the reasons why management selected that policy, the policy preferred by the auditor, and the reason he or she preferred the other policy.

c. Discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the entity's accounting policies as applied in its financial reporting. See paragraphs 13 to 15.

11. Critical accounting policies and practices include those that (*a*) are disclosed as critical accounting policies within management's discussion and analysis, or (*b*) in the auditor's judgment, are both most important to the portrayal of the entity's financial condition and results of operations and require management's most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.

12. Alternative treatments within generally accepted accounting principles for accounting policies and practices related to material items include both those accounting principles for which different accounting policies and practices are generally accepted (for example, inventory pricing methods, depreciation methods, and the method of accounting for stock based compensation), and those for which no authoritative accounting literature exist.

~~Auditor's Judgments About the Quality of the Entity's Accounting Principles~~

13~~11~~. ~~In connection with each SEC engagement (see paragraph .01), the auditor should discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the entity's accounting principles as applied in its financial reporting.~~ ***The discussion of the auditor's judgments about the quality, not just the acceptability, of the entity's accounting policies as applied in its financial reporting*** ~~Since the primary responsibility for establishing an entity's accounting principles rests with management, the discussion generally would include management as an active participant. The discussion~~ should be open and frank and, since the primary responsibility for establishing an entity's accounting policies rests with management, the discussion generally would include management as an active participant.

[6] ***Including any significant modifications to such disclosures proposed by the auditor but rejected by management.***

[7] ***See AU sec. 411,*** **The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles** ***(AICPA,*** **Professional Standards,** ***vol. 1, AU sec. 411).***

[8] ***For specific transactions, the auditor should communicate the significant underlying facts, the major financial statement amounts, presentations, and disclosures impacted, and, if applicable, the entity's existing accounting policies for similar transactions. If the alternative selected does not conform to the entity's existing accounting policies, the auditor should also communicate the basis for management's selection of the alternative policy.***

[9] ***Including the reasons why the selected alternative was selected and, if the auditor's preferred alternative was not selected, the reasons why it was not selected.***

14. The discussion generally should include such matters as the consistency of the entity's accounting policies and their application, and the ***understandability***[10]~~clarity~~ and completeness of the entity's financial statements, which include related disclosures. The discussion should also include items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements.[11] Examples of items that may have such an impact are the following:

- Selection of new or changes to accounting policies
- Estimates, judgments, and uncertainties
- Unusual transactions
- Accounting policies relating to significant financial statement items, including the timing of transactions and the period in which they are recorded

15. Objective criteria have not been developed to aid in the consistent evaluation of the quality of an entity's accounting ***policies*** ~~principles~~ as applied in its financial statements. The discussion should be tailored to the entity's specific circumstances, including accounting applications and practices not explicitly addressed in the accounting literature, for example, those that may be unique to an industry.

Other Information in Documents Containing Audited Financial Statements

16~~12~~. The audit committee often considers information prepared by management that accompanies the entity's financial statements. An example of information of this nature would be ~~the~~ management's discussion and analysis ~~of financial condition and results of operations~~ that certain entities that file reports with the SEC are required to present in annual reports to shareholders. AU sec. 550, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards,* vol. 1, AU sec. 550), establishes the auditor's responsibility for such information.[12] The auditor should discuss with the audit committee his responsibility for other information in documents containing audited financial statements, any procedures performed, and the results.

Disagreements With Management

17~~13~~. Disagreements with management may occasionally arise over the application of accounting principles to the entity's specific transactions and events and the basis for management's judgments about accounting estimates. Disagreements may also arise regarding the scope of the audit, disclosures to be included in the entity's financial statements, and the wording of the auditor's report. The auditor should discuss with the audit committee any disagreements with management,[13] whether or not satisfactorily resolved, about matters that individually or in the aggregate could be significant to the

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[10] Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 2,* Qualitative Characteristics of Accounting Information*, defines understandability as "the quality of information that enables users to perceive its significance."

[11] These characteristics of accounting information are discussed in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information.* FASB Concepts Statement No. 2 notes that consistently understating results or overly optimistic estimates of realization are inconsistent with these characteristics.

[12] Guidance on the auditor's consideration of other information is also provided by AU sec. 558, *Required Supplementary Information* (AICPA, *Professional Standards,* vol. 1, AU sec. 558); AU sec. 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor Submitted Documents* (AICPA, *Professional Standards,* vol. 1, AU sec. 551); and AU sec. 711, *Filings Under the Federal Securities Statutes* (AICPA, *Professional Standards,* vol. 1 , AU sec. 711)..

[13] The glossary to FASB Statement of Financial Accounting Standards No. 57, *Related Party Disclosures* (AC section R36), defines management as follows:

> Persons who are responsible for achieving the objectives of the enterprise and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management normally includes members of the board of directors, the chief executive officer, chief operating officer, vice presidents in charge of principal business functions (such as sales, administration, or finance), and other persons who perform similar policy-making functions. Persons without formal titles also may be members of management.

entity's financial statements or the auditor's report. For purposes of this section, disagreements do not include differences of opinion based on incomplete facts or preliminary information that are later resolved.

Consultation With Other Accountants

18~~14~~. In some cases, management may decide to consult with other accountants about auditing and accounting matters. When the auditor is aware that such consultation has occurred, he should discuss with the audit committee his views about significant matters that were the subject of such consultation.[14]

Major Issues Discussed With Management Prior to Retention

19~~15~~. The auditor should discuss with the audit committee any major issues that were discussed with management in connection with the initial or recurring retention of the auditor including, among other matters, any discussions regarding the application of accounting principles and auditing standards.

Difficulties Encountered in Performing the Audit

20~~16~~. The auditor should ***discuss with*** ~~inform~~ the audit committee ~~of~~ any serious difficulties ~~he~~ encountered in dealing with management related to the performance of the audit. This may include, among other things, unreasonable delays by management in permitting the commencement of the audit or in providing needed information, and whether the timetable set by management was unreasonable under the circumstances. Other matters that the auditor may encounter include the unavailability of client personnel and the failure of client personnel to complete client-prepared schedules on a timely basis. If the auditor considers these matters significant, he should inform the audit committee.

Significant Written Communications Between the Auditor and Management

21. The auditor should determine that the audit committee has received copies of all material written communications between the auditor and management. Examples include but are not limited to engagement letters[15], management representation letters,[16] reports issued on significant deficiencies or material weaknesses,[17] and written communications on accounting, auditing, internal control, or operational matters.[18]

Timing of Communications

22. For SEC engagements, the matters required to be communicated by the following paragraphs of this Statement should be communicated to the audit committee prior to the filing of the auditor's report with the appropriate regulatory agency:[19]

- ***AU sec. 380.05, "Management Judgments and Accounting Estimates"***
- ***AU sec. 380.07, "Uncorrected Misstatements"***
- ***AU secs. 380.08 to .15, "Accounting Policies and Alternative Treatments"***

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[14] Circumstances in which the auditor should be informed of such consultations are described in AU sec. 625, *Reports on the Application of Accounting Principles* (AICPA, *Professional Standards,* vol. 1, AU sec. 625.07).

[15] ***See AU sec. 310,*** **Appointment of the Independent Auditor** ***(AICPA,*** **Professional Standards,** ***vol. 1, AU sec. 310).***

[16] ***See AU sec. 333.***

[17] ***See AU sec. 325. These communications may also be contained in other communications, for example, management letters.***

[18] ***Independence Standards Board Statement No. 1,*** **Independence Discussions with the Audit Committee*****, describes communications that the auditor should make directly with the audit committee of certain entities.***

[19] ***To the extent applicable, if the auditor's report is included or incorporated in any subsequent filing (e.g., in a registration statement or other filings, such matters should be communicated prior to the subsequent filing. For investment company filings, the communications are required to be made annually, and any changes in any previously reported information are required to be communicated in an update within 90 days of the filing.***

- ***AU sec. 380.21, "Significant Written Communications Between the Auditor and Management"***

The auditor should also attempt to make the other communications required by this Statement prior to the filing of the auditor's report with the appropriate regulatory agency; however, if such communications cannot be made prior to the filing, they should be made as soon as practicable in the circumstances.

23. ~~The~~ ***For engagements other than SEC engagements, the*** communications specified by this Statement ~~are incidental to the audit. Accordingly, they~~ are not required to occur before the issuance of the auditor's report on the entity's financial statements***,*** as long as the communications occur on a timely basis. ~~There may be occasions, however, when discussion of certain of the matters (specified by paragraphs .06 through .14) below) with the audit committee prior to the issuance of the report may, in the auditor's judgment, be desirable.~~

24. Generally, ***except for the matters discussed in AU sec. 380.10,*** it is not necessary to repeat the communication of recurring matters each year. Periodically, however, the auditor should consider whether, because of changes in the audit committee or simply because of the passage of time, it is appropriate and timely to report such matters.

Documentation Requirements

25. The communications may be oral or written. If information is communicated orally, the auditor should document the communication. ~~by appropriate memoranda or notations in the working papers~~[20] When the auditor communicates in writing, the ~~report~~ ***communication*** should indicate that it is intended solely for the information and use of the audit committee or the board of directors and, if appropriate, management, and is not intended to be and should not be used by anyone other than these specified parties. ***Regardless of the form of communication, the auditor should read the minutes, if any, of the audit committee meetings for consistency with the auditor's understanding of the communications.***

~~[20] The auditor may wish to review the minutes, if any, prepared by the audit committee for consistency with the auditor's understanding of the communications.~~

PROPOSED AMENDMENT
AU SECTION 722, *INTERIM FINANCIAL INFORMATION*

This proposed amendment adds new paragraphs 53 and 54 and new footnote 38 to AU sec. 722, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 722). Subsequent paragraphs and footnotes are renumbered. New material is shown in bold italics. The provisions of paragraph 53 are effective for reviews of interim financial information completed on or after October 31, 2003. The provisions of paragraph 54 are effective for reviews of interim financial information for periods ending on or after September 15, 2003. Early application is permissible.

RETENTION OF REVIEW DOCUMENTATION

53. The accountant should adopt reasonable procedures to retain review documentation for a period of seven years after the accountant concludes the audit of financial statements of the fiscal year including the period under review or, if no such audit report is issued, from completion of the review procedures for the last interim period reviewed within that fiscal year and for such additional period of time sufficient to satisfy any applicable legal or regulatory requirements for records retention.[38]

REQUIREMENT FOR REVIEWING PARTNER

54. The proposed Statement on Auditing Standards,* Review of SEC Engagements by a Reviewing Partner*, states that reviews of interim financial information in accordance with this Statement should be subject to a reviewing partner's review. (See the proposed Statement for further guidance.)

[38] ***Accountants are also required by SEC Rule 2-06 of Regulation S-X to retain certain other records relevant to the review for a period of seven years from completion of the review.***