

■ Public Company Financial Executive Briefing ■

NEW ACCOUNTING STANDARDS THAT REVISE REQUIREMENTS FOR ASSESSING RISK IN AUDITS

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EXECUTIVE SUMMARY

On December 17, 2009, the PCAOB repropoed changes to the current auditing standards that would revise the requirements for assessing risk in an audit. The intention of these standards is to improve audits by enhancing the effectiveness of an author's assessment of, and response to, risk. These changes would establish requirements for audit procedures performed throughout the audit, from the planning stages through the audit results evaluations in forming the opinion. The PCAOB is seeking comments to the repropoed standards through March 2, 2010, which will be carefully considered before taking final action.

BACKGROUND

The proposed changes build upon, and attempt to improve, the framework established by the existing standards, rather than replacing that framework altogether. Although several of the interim standards will be superseded, the concepts underpinning the proposed standards should be familiar to most auditors. The intention of these standards is to improve audits by enhancing the effectiveness of an author's assessment of, and response, to risk.

Audit risk can be described as the risk that the auditor will express an inappropriate opinion

when the financial statements are materially misstated. The objective of an audit of financial statements is to limit audit risk to low level, so that the auditor can opine with reasonable assurance that the financial statements present fairly, in all material respects, a company's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles ("GAAP").

The proposed changes are expected to do the following:

- Encourage a risk assessment process that results in the tailoring of audit procedures to a company's size and complexity by providing auditors the ability to exercise their professional judgment in meeting the requirements of the standards
- Serve as a foundation for future standards as it sets forth fundamental aspects of the audit, such as assessing risk and performing tests of controls and substantive procedures
- Enhance integration of the audits for financial statements and internal controls over financial reporting
- Emphasize auditor's responsibilities for considering risk of fraud during audit
- Eliminate unnecessary differences between PCAOB and other risk assessment standards

SUMMARY OF CHANGES

The proposed risk assessment standards are summarized below:

- **Audit Risk in an Audit of Financial Statements.** This proposed standard describes the components of audit risk and the auditor's responsibilities for reducing audit risk to an appropriately low level, in order to obtain reasonable assurance in an audit of financial statements. The auditors must plan and perform the audit to obtain reasonable assurance about whether there is material misstatement in the financial statements due to error or fraud. The auditors must apply due professional care and must obtain sufficient, appropriate audit evidence.
- **Audit Planning and Supervision.** This proposed standard describes the auditor's responsibilities for planning the audit, including assessing matters that are important to the audit, and establishing an appropriate audit strategy and audit plan. The auditors should develop a written audit plan that should include a description of the nature, timing and extent of the risk assessment, tests of controls, and procedures that are required to be carried out. The proposed standard also describes the responsibilities of the engagement partner and other engagement team members for supervising and reviewing the work of the engagement team.

■ **Identifying and Assessing Risks of Material Misstatement.** This proposed standard describes the auditor's responsibilities for identifying and assessing risks of material misstatement. The risk assessment process discussed in the proposed standard includes information-gathering procedures to identify risks (e.g., obtaining an understanding of the company, its environment, and its internal control) and analysis of the identified risks. The auditor's assessment procedures apply to both the audit of internal control over financial reporting and the audit of the financial statements. Auditors must obtain an understanding of the company and its environment to find the activities that could have a significant effect on the risks of material misstatement.

■ **The Auditor's Responses to the Risks of Material Misstatement.** This proposed standard sets forth the auditor's responsibilities for

responding to the risks of material misstatement, including overall responses related to the general conduct of the audit and responses involving specific audit procedures. Specifically, auditors should apply professional skepticism when gathering and evaluating audit evidence.

■ **Evaluating Audit Results.** This proposed standard describes the auditor's responsibilities regarding the process of evaluating the results of the audit in order to form the opinion(s) to be presented in the auditor's report. This process includes evaluating uncorrected misstatements and control deficiencies identified during the audit.

■ **Consideration of Materiality in Planning and Performing an Audit.** This proposed standard sets forth the auditor's responsibilities for applying the concept of materiality, as described by the federal securities laws, in planning the audit and determining the scope of the audit

procedures.

■ **Audit Evidence.** This proposed standard sets forth the auditor's responsibilities regarding designing and applying audit procedures to obtain sufficient, appropriate evidence to support the opinion(s) in the auditor's report. In particular, it discusses the principles for determining the sufficiency and appropriateness of audit evidence.

The proposed standards will supersede five interim auditing standards: AU sec. 311, Planning and Supervision, AU sec. 312, Audit Risk and Materiality in Conducting an Audit, AU sec. 313, Substantive Tests Prior to the Balance Sheet Date, AU sec. 319, Consideration of Internal Control in a Financial Statement Audit, and AU sec. 326, Evidential Matter.

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