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August 31, 2005

Hiram Hasty, Technical Manager
Audit and Attest Standards, File 3044
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

By e-mail: hhasty@aicpa.org

Re: Auditing Standards Board's Exposure Draft of "Eight Proposed Statements on Auditing Standards Related to Risk Assessment (June 2005)", consisting of the following:

- Amendment to "Due Professional Care in the Performance of Work" of Statement on Auditing Standards No. 1, *Codification of Auditing Standards and Procedures*
- Amendment to Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards*
- Audit Evidence
- Audit Risk and Materiality in Conducting and Audit
- Planning and Supervision
- Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement
- Performing Audit Procedures in Response to the Assessed Risks and Evaluating the Audit Evidence Obtained
- Amendment to Statement on Auditing Standards No. 39, *Audit Sampling*

Dear Mr. Hasty:

The New York State Society of Certified Public Accountants, the oldest state accounting association, represents approximately 30,000 CPAs that will implement the provisions proposed in the captioned exposure draft. NYSSCPA thanks AICPA for the opportunity to comment on its exposure draft.

The NYSSCPA's Auditing Standards and Procedures Committee deliberated the draft and prepared the attached comments, in collaboration with the NYSSCPA's Accounting and Auditing Oversight Committee. If you would like additional discussion with us, please contact Paul D. Warner, Chair of the Accounting and Auditing Oversight Committee at (516) 463-6994, Mark I. Mycio the Chair of the Auditing Standards and Procedures Committee at (212) 372-1421, or Ernest J. Markezin, NYSSCPA staff, at (212) 719-8303.

Sincerely,

Stephen F. Langowski
President

Attachment

new york state society of

NYSSCPA

certified public accountants

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**NEW YORK STATE SOCIETY OF
CERTIFIED PUBLIC ACCOUNTANTS**

**COMMENTS TO THE AUDITING STANDARDS BOARD ON THE
EIGHT PROPOSED STATEMENTS ON AUDITING STANDARDS RELATED
TO RISK ASSESSMENT (JUNE 2005)**

AUGUST 31, 2005

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**NEW YORK STATE SOCIETY OF
CERTIFIED PUBLIC ACCOUNTANTS**

**Comments to the Auditing Standards Board on the
Eight Proposed Statements on Auditing Standards Related to Risk Assessment
(June 2005)**

August 31, 2005

General Comments

The Auditing Standards Board issues Statements on Auditing Standards (SASs) in order to clarify and/or establish policies which govern the practice of auditing. It previously issued Audit Guides in order to “flesh out” the standards by providing detailed guidance and examples. A number of the SASs proposed in this release should be released as Audit Guides not as SASs. One, in particular, appears to be nothing more than a revision of the SAS 55 Audit Guide, “Consideration of Internal Control in a Financial Statement Audit”.

A second general observation we wish to note is that when the proposed standards refer to matters with applicability to both GAAP and OCBOA, we believe that such applicability to OCBOA in addition to GAAP should be explicitly stated. We noted in one case where this was mentioned in a footnote (paragraph 14 of the proposed standard on “Audit Evidence”) and two other applicable cases where the guidance was omitted entirely (paragraphs 7.b. and 49 of the standard on “Audit Risk and Materiality”).

As a final general comment, we wish to express our serious concern regarding the length of the comment period provided with these exposure drafts. We understand that the Board may have considered this as largely a re-exposure of previously exposed material. However, given the volume of the material exposed, the fact that the previous exposure period occurred more than two years ago, and the fact that substantive changes have been made to the previously exposed material, we believe that the comment period was inappropriately short. Furthermore, given the fact that the proposed effective dates are generally for fiscal years beginning after 2006, we believe that the comment period was unnecessarily short.

Matters on Which the Exposure Drafts Requested Specific Comment

1. Classification of Misstatements Identified by the Auditor

The exposure drafts continue to use the phrase “likely misstatements” to characterize misstatements that arise from differences in judgment between management’s and the auditor’s estimates, and as differences based on extrapolation of sampling errors. The use of the word ‘likely’ is misleading and inaccurate. The more accurate term is ‘estimated misstatements’. Additionally, the guidance concerning such misstatements needs to be clarified. The exposure draft implies that the auditor’s only course of action when presented with such differences is to request that management examine the area in

question to identify and correct misstatements that are presumed to exist. There is presently diversity in practice. At times, such extrapolated “errors” and differences between subjective estimates are recorded as adjustments. The standard should state unequivocally when such adjustments are appropriate. It should also explain what the distinguishing criteria are for when to book an adjustment and when to continue working on the area to identify and correct the misstatements presumed to exist.

2. Effect of Misstatements Related to the Prior Period

The evaluation of materiality should be based on the method that produces the most material effect in the circumstances on either of the primary financial statements, balance sheet, income statement or cash flow. Accordingly, both the rollover and the iron curtain methods should be considered in these evaluations. Additionally, we note that Footnote 18 states that measurement of the effect on current periods of misstatements uncorrected in prior periods is “not addressed in this section.” That statement seems to be in contradiction to the fact that is precisely the subject the section is addressing.

Other Specific Comments

1. Amendment to “Due Professional Care in the Performance of Work”

We agree that the concept of “low risk of material misstatement” and “high level of assurance” is consistent with the increased effectiveness that should be expected from the “risk-focused” methodology that is being proposed with these exposure drafts. Simply leaving the term ‘reasonable assurance’ in place does not recognize this focus.

2. Amendments to Statement On Auditing Standards No. 95

We concur with the use of the word “must” since it designates an absolute requirement, and agree that such designation is appropriate.

We agree that substituting the term “appropriate audit evidence” for “competent evidential matter” is in keeping with plain-English usage and enhances the understandability of the standard.

Finally, we agree with the change to the foundation of the audit process, expressed in the wider scope of understanding the entity and its environment, not just its internal control, and converting this enhanced understanding into a more focused, risk-sensitive audit.

3. Audit Evidence

Paragraph 9 states that “an audit rarely involves the authentication of documentation...” We are troubled by this statement. We may not directly authenticate documentation but we frequently do so by inference. One of the purposes of test of control procedures is to establish that the documentation is authentic.

Paragraph 10 classifies CAATs as an example of an additional audit procedure. In fact, in complex computer-based environments, CAATs may become the primary audit procedure.

Paragraph 15 significantly increases the categorization of assertions. This increase does not appear to reinforce understanding of the importance of sufficient evidence. Furthermore, SAS 31 paragraphs .04-.08 have examples for each type of assertion.

Paragraph 22, last sentence, should be as follows: ".....assertions associated with substantive procedures to support the risk assessment. The auditor should perform tests of controls to obtain audit evidence about their implementation to supplement the auditor's understanding of the effectiveness of planned substantive procedures. The phrase: "In addition, when the planned level of substantive procedures alone does not provide sufficient appropriate audit evidence..." should be eliminated.

This paragraph should point out that a walk-through of the control procedures is mandatory.

Paragraph 38 should address the concept of "Reconciliation" not just "Recalculation."

4. Audit Risk and Materiality in Conducting an Audit

Paragraph 6 contains assumptions about users which may not be appropriate, especially with less sophisticated users (e.g., smaller client organizations).

Paragraph 10, the last sentence, should be changed to read as follows "In contrast, when a fraud or other illegal act is detected..."

Paragraph 11, we agree with the use of "must" instead of "should."

Paragraph 13, examples of criteria for determining nonquantitative audit risk assessment should be provided in a footnote.

Paragraph 26 includes the audit risk model and concludes by stating that the model is not intended to be a mathematical formula. In fact, its use could lead to absurd results. For example, if each of the components has a 100% risk of failure to detect, the audit risk would only be 1%. Also, please refer to our comments about Table 1 in our comments on Amendment to Statement on Auditing Standards No. 39.

Paragraph 37 states "Although the auditor should be alert for misstatements that could be qualitatively material, it ordinarily is not practical to design audit procedures to detect them."

Paragraph 43 uses a new terminology, "trivial." The standard should clarify this concept and state why it is necessary to differentiate between immaterial and trivial.

Paragraph 51.b, the example given is confusing and should instead reflect what may be appropriate, rather than what may be inappropriate. Consider changing the wording to “For example, it may be appropriate to offset misstatements of items within the same account balance in the financial statements.”

Paragraph 68 states that “The auditor should document.” The use of the word “must”, would be more appropriate.

5. Planning and Supervision

The exposure draft should initially clarify what is meant by “audit plan”, and whether this term is used interchangeably with the term “audit program”.

Paragraph 9, the last sentence, states “These matters may be communicated in the form of an engagement letter. “May” should be changed to “should.” See paragraph 8 which uses “should.”

Paragraph 17, the last work in the third sentence “easier” should be changed to “less formal.”

Paragraph 23 should include performance of substantive tests as well tests of IT controls, For example, the analysis of subsequent receivables activity or the re-performance of the client’s receivables aging analysis.

Appendix A.2, add “Review of audit issues from previous year(s) engagements, whether done by the continuing or predecessor firm to determine the correction, if any, of material weaknesses or reportable conditions that were present on those prior audits.”

Appendix A.3 should include a reference to management representation letter.

6. Understanding the Entity and its Environment and Assessing the Risk of Material Misstatement

This ED has very helpful guidance in the form of examples and appendices. We support their inclusion in the Standard. However, we recommend removing all the examples and “such as” guidance from the body of the Standard and moving them to the footnotes. Then each paragraph in the standard will focus just on the essential audit procedures and principles. While the explanatory material and guidance is welcome, their removal to the footnotes will streamline the Statement and will allow auditors to apply its requirements. An alternative approach would be to place these examples in an Audit Guide such as the SAS 55 Audit Guide, “Consideration of Internal Control in a Financial Statement Audit”.

We understand the term “assertion levels” used throughout the document to mean assertions at the entire financial statement level and at the account level (consistent with paragraph 16). We suggest defining the term “assertion levels” much earlier in the document.

We suggest that a glossary of commonly used terms, or a cross reference to the applicable standard where the term is either discussed or defined, would be a next step in modernizing the existing standards.

We note the admonition that “substantive procedures alone do not provide sufficient appropriate audit evidence” in paragraph 2, 110 and 118 et seq. We believe this guidance is most important to auditors using a “substantive” rather than a “risk based” approach. We support the ED’s requirement that risk assessment procedures, understanding the entity and internal controls, and an evaluation of what could go wrong with the financial statements, should be documented in every audit.

We recommend that language be inserted into the auditing standards to eliminate the necessity to use the phrase “should consider,” “by considering,” or similar words. The auditor’s are always required to apply professional judgment and plan and perform the audit with an attitude of professional skepticism (see pars. 4, 17, 18 and elsewhere in the ED). It is unnecessary to say something that is interpreted to mean the auditor “is required to think about.” The Standard should state what is required and the auditor should then document whether that procedure was applied or was not applicable. One suggestion is to put a legend at the end of each Standard saying something like “the auditor must apply Generally Accepted Auditing Standards at all times in the performance of the audit and the preparation of the report.” This would be very similar to the accounting standards issued by the FASB each of which contains the motherhood legend that “the provisions of this Statement need not be applied to immaterial items.”

Paragraph 11 bullet 5 refers to the walk-throughs. This procedure should be required in every audit. The term “ordinarily” implies that it is not mandatory.

The last sentence of Paragraph 12 states that “the auditor should make inquiries...” The word “should”, should be replaced with “must.”

Paragraph 18 is not strong enough and should indicate the auditor “must” plan. The same comment is applicable to the first sentence in paragraph 29.

Paragraph 20 discusses audits performed by the audit partner and requires the consideration of factors that may be necessary in the engagement “such as personnel possessing specialized skills.” We are not clear as to exactly what this means and suggest that the discussion and requirements in this paragraph be expanded and include, in a footnote, other examples.

The last sentence of paragraph 32 says, “However, the auditor does not have a responsibility to identify or assess all business risks.” We do not see this as defining the outer limit of the auditor’s responsibility and leaves open the question as to just how much should be identified. We also do not believe this language protects auditors from litigation and for these reasons recommend its deletion.

Paragraph 39 ends with “may indicate the potential risk of management bias in the preparation of financial statements.” We recommend that this paragraph should then address (or cross reference to) what the auditor must then do about this specific situation.

Paragraph 42 says “design tests of controls, when applicable, and substantive procedures.” We suggest “Design (a) tests of controls (if applicable), and (b) substantive procedures.”

In paragraph 48, the next to the last sentence ends with the phrase “determine whether they have been implemented.” The phrase “by performing a walk-through” should be added.

We recommend clarifying and expanding paragraph 54 where it is stated “The auditor should consider the design of a control in determining whether to consider its implementation. An improperly designed control may represent a material weakness.”

Paragraph 56 refers to “some automation.” Additional clarification is needed since microcomputer-based accounting systems provide “some automation.” Generally, microcomputer-based systems do not provide any better controls than do manual systems.

The examples in paragraph 87 do not belong in the body of an SAS. We previously indicated that items such as these should either be in a footnote or preferably in an auditing guide.

Paragraph 92 is an example of the redundancies in the ED. We recommend that the ED be carefully edited to eliminate them.

Also in need of clarification and modification is the last sentence in paragraph 104: “When the risk assessment is based on an expectation that controls are operating effectively to prevent or detect material misstatement, individually or when aggregated, at the relevant assertion level, the auditor should perform tests of the controls that the auditor has determined to be suitably designed to prevent or detect a material misstatement in the relevant assertion to obtain audit evidence that the controls are operating effectively, as described in the proposed SAS *Performing Procedures*.”

7. Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained

The exposure draft uses “material misstatement” where ‘tolerable misstatement’ is the appropriate term. For example, paragraphs 25, 26 and 51a are inconsistent with paragraph 17 (as renumbered) of the Amendment to SAS #39. Terminology should be consistent, as between SASs.

We agree with the statement in paragraph 35 that “the absence of misstatements detected by substantive procedures does not provide audit evidence that controls related to the relevant assertion being tested are effective.” It is for this reason that tests of controls

should be encouraged. Tests of controls may, in fact, establish that the substantive procedures can not be relied on. This paragraph should include such a warning.

Paragraph 43 states that “if ...the auditor plans to rely on controls that have not changed since the last time they were tested, the auditor should test operating effectiveness...at least every third audit.” We find this to be a very risky approach. The only way to determine the operating effectiveness of a control is to test it. Various factors may affect the functioning of previously tested controls even in the best controlled environments. A simple patch in the vendor’s operating system could jeopardize the effectiveness of a computer-based accounting control or the integrity of the data being audited. If the control is to be relied on it must be tested.

Paragraph 46 only requires the current year’s testing of the operating effectiveness of controls when there is a significant risk of misstatement. As indicated in our paragraph 43 comment, the criteria for current year testing should not be the significance of the risk, but the intent to rely on the operating effectiveness of the controls.

8. Amendment to Statement On Auditing Standards No. 39

The proposed amendment to statement on Auditing Standards No. 39, *Audit Sampling*, marginally improves that statement. Nevertheless, the Auditing Standards Board has missed an opportunity to advance this aspect of audit testing into the twenty-first century. Our profession continues to stand alone in its failure to acknowledge the superiority of statistical methods when performing tests of details. This is especially odd, given that a contemporaneous accounting pronouncement (SFAS 123R) requires an accounting application of statistical procedures that are considerably more sophisticated than the commonly used statistical sampling procedures in auditing. Moreover, federal agency audits now require the use of statistical sampling (See, for example, “Effective Implementation of the Improper Payments Information Act of 2002 Is Key to Reducing the Government’s Improper Payments.” Statement of McCoy Williams, Director, Financial Management and Assurance, United States General Accounting Office. GAO-03-991T.) Statistical sampling should be the preferred method for performing tests of details, where appropriate.

Paragraph 22, as renumbered, requires that applying factors in determining sample size “...should result in a sample size comparable to the sample size resulting from an efficient and effectively designed statistical sample, considering the same sampling parameters.” This is a positive step. However, it is merely an indirect expression of what is widespread knowledge – that statistical sampling is the superior tool for performing tests of details where sampling is appropriate, and the standard against which a test of details will be judged. If the Auditing Standards Board hopes that this comparability requirement will encourage auditors to adopt statistical sampling without actually requiring such adoption, it is likely to fail. A similar approach was taken when SAS 39 was originally drafted. By requiring the auditor to consider sampling risks, to select samples that can be expected to be representative, and to project misstatements, the

Statistical Sampling Subcommittee of the ASB hoped that a rational auditor would choose the statistical approach. Instead, the opposite occurred.

The revision fails to clarify, by explicit definition, the term “statistical sampling.” Statistical sampling is probability sampling, wherein every item in the sampling frame has a known chance of being selected, and wherein selection of specific sample items is determined by chance. The results of such samples are measurable by application of appropriate mathematical procedures. The standard (as well as the AICPA Audit Guide, *Audit Sampling*) leaves to auditor discretion the decision to evaluate judgmentally any probability sample that the auditor has selected, by the convenient device of labeling such a sample “non statistical.” Such a sample remains nevertheless measurable.

Paragraph 31, as renumbered, states:

Sampling applies when the auditor needs to estimate whether the rate of deviation from a prescribed procedure exceeds a tolerable rate, for example in testing a matching process or an approval process

The last sentence in the paragraph states,

Sampling does apply when the auditor needs to estimate whether the rate of deviation from a prescribed control procedure exceeds a tolerable rate, for example in testing a matching process or an approval process.

This is poorly worded and is at variance with practice. Auditors may incorrectly conclude that an error condition (or, alternatively, risk) is acceptable so long as the sample error rate does not exceed the maximum tolerable rate. In fact, the standard for this type of test has always been to determine whether the upper limit of the deviation rate exceeds the maximum tolerable rate. If the auditor bases a decision as to control effectiveness on whether or not the observed deviation rate exceeds the maximum tolerable rate, and the actual deviation rate just exceeds the specified maximum tolerable rate, then the auditor will be deciding incorrectly approximately 50% of the time. We suggest the following wording:

*Sampling applies when the auditor needs to **decide** whether the rate of deviation from a prescribed procedure **is no greater than** a tolerable rate, for example in testing a matching process or an approval process.*

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*Sampling does apply when the auditor needs to **decide** whether the rate of deviation from a prescribed control procedure **is no greater than** a tolerable rate, for example in testing a matching process or an approval process.*

The modification of Table 1, as renumbered, to combine inherent and control risk is helpful. The table, however begs the question: How can one place 90% reliance (10%

risk), or *any* reliance, on analytical procedures if the auditor's assessment of risk of material misstatement is 100%? Yet, the table admits such a situation. Analytical procedures are weak procedures that provide only negative assurance when applied to tests of data that can be otherwise examined by inspection, observation, or confirmation. Table 1, as renumbered, perpetuates a misconception about the ability of analytical procedures to provide assurance as to the absence of material misstatement. Moreover, the table sanctions reducing the effectiveness of the test of details to that of a coin flip where the auditor's assessed risk of material misstatement is 100%.