new york state society of
NYSSCPA
certified public accountants
530 fifth avenue, new york, ny 10036-5101
www.nysscpa.org

May 2, 2003

Julie Anne Dilley
Technical Manager Audit and Attest Standards
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

By email: jdilley@aicpa.org

File 3044

Dear Ms. Dilley

The New York State Society of Certified Public Accountants, the oldest state accounting association, represents 30,000 CPAs that will implement the provisions contained in the exposure draft of seven Statements on Auditing Standards related to audit risk. NYSSCPA thanks ASB for the opportunity to respond.

The NYSSCPA Auditing Standards and Procedures Committee drafted the attached comments. If you would like additional discussion with the committee, please contact Margaret Wood, the committee's chair, at (212) 542-9528, or Robert Colson, NYSSCPA staff, at (212) 719-8350.

Sincerely,

Jo Ann Golden
President

new york state society of
NYSSCPA
certified public accountants
530 fifth avenue, new york, ny 10036-5101
www.nysscpa.org

NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

Comments to the Auditing Standards Board

On

Exposure Draft of Seven Statements on Auditing Standards Related to Audit Risk

May 2, 2003

Principal Drafters

Neal Hitzig
Bruce Nearon
Julian Jacoby
Fred Goldstein

NYSSCPA 2002 - 2003 Board of Directors

Jo Ann Golden, President
Jeffrey R. Hoops, President-elect
Thomas E. Riley, Secretary
Frank J. Aquilino, Treasurer
Laurence Keiser, Vice President
Stephen F. Langowski, Vice President
Carol C. Lapidus Vice President
Ian M. Nelson Vice President
Louis Grumet, ex-officio
William Aiken
Spencer L. Barback
Michael G. Baritot
Rosemarie A. Barnickel
Peter L. Berlant
Arthur Bloom
Andrew Cohen
Walter Daszkowski
Michael J. DePietro
Katherine K. Doran
Barbara S. Dwyer
Andrew M. Eassa
David Evangelista
Franklin H. Federmann
Peter H. Frank
Angelo J. Gallo
Neville Grusd
David W. Henion
Nancy A. Kirby
Vincent J. Love
Sandra A. Napoleon-Hudson
Nancy Newman-Limata
Raymond M. Nowicki
Kevin J. O'Connor
Robert S. Peare
Mark A. Plostock
Joseph J. Schlegel
Robert E. Sohr
Robert A. Sypolt
Edward J. Torres
Beth Van Bladel
Howard D. Weiner
Philip Wolitzer

NYSSCPA 2002 – 2003 Auditing Standards and Procedures Committee

Margaret A. Wood, Chair
Robert W. Berliner
Christopher A. Brown
Romolo R. Calvi
George Fanourakis
Audrey A. Foster
Fred R. Goldstein
Neal B. Hitzig
Mary-Jo Kranacher
Elliot A. Lesser
Joseph E. Manfre
Mark Mycio
Wayne Nast
Bruce H. Nearon
Bernard H. Newman
Raymond A. Norton
R. Michael Peress
Victoria L. Pitkin
Joseph F. Schick
Thomas Sorrentino
George I. Victor
William H. Walters
Paul D. Warner
Robert N. Waxman

NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

Comments to the Auditing Standards Board
On
Exposure Draft of Seven Statements on Auditing Standards Related to Audit Risk
May 2, 2003

General Comments

The proposed Statements on Auditing Standards, along with such recently issued statements as SAS 99, offer the Auditing Standards Board a critical opportunity to take steps that will restore confidence in the public accounting profession, in light of the broad concerns, expressed by the investing public, by regulators, and by members of the profession itself.

The proposed statements represent a significant step along a path that will result in improving audit practice and we are supportive of the Board's effort to revise existing guidance to achieve that effect.

Nevertheless, more can be done to restore confidence in our profession, and, moreover, the proposed statements preserve existing ambiguities or create new ones that should be addressed. The specific comments that follow identify these areas.

The proposed effective date for implementation of this new standard is inconsistent with the urgency suggested by the events that have preceded the exposure drafts. The proposed statements should be effective for all audits performed after December 31, 2003.

Inherent risk should not be a factor for determining achieved audit risk, because it invites the auditor to obtain assurance from a subjective factor, one that is not based on audit evidence. This is a conceptual flaw in the audit risk model. The concept of inherent risk best serves the auditor as a basis for deciding what level of audit risk should be achieved, and not the level that has been achieved. Nevertheless, we are pleased to observe that the drafts continue a trend to meld inherent risk with control risk.

The exposure draft text frequently admonishes an auditor to consider some factor without indicating how that factor affects the conduct of the audit. In some cases, such as in paragraph 10 of the Audit Evidence draft, the implications are clear. In other cases, such as in Planning and Supervision, the text does not suggest what may be the impact of the recommended considerations. For example, how would planning and supervision differ between an audit of an entity that uses emerging technologies and one that does

not? Wherever there is an admonishment for the auditor to consider a factor, that factor's effect should be discussed.

The New York State Society has, on a number of occasions, asked the Auditing Standards Board to provide materiality implementation guidance. Yet, the proposed SASs do not provide sufficient guidance regarding planning materiality. Our concern for this deficiency arises from findings in many peer reviews, in which the basis for the extent (scope) of an audit procedure is either not adequately documented, or is virtually unrelated to the preliminary audit materiality determination.

A former chair of our committee conducted a comparative study of materiality determinations for various size companies. He noted that guideline materiality thresholds used by the large firms for scoping audits is roughly 30% greater than those applied by smaller firms that use the Practitioners' Planning Company (PPC) Small Audit Process. (used by most small firms). These variations in practice result in significant differences in extent of testing between the two groups. All firms in the study used the larger of assets or revenue as the calculation base.

The ASB should reconsider its approach to materiality and revise the ED because it is likely that, given the current auditing environment, the PCAOB will address this matter. We recognize that significant elements of the profession may be reluctant to revisit this matter, because of possible legal exposure issues associated with defending work against a more definitive auditing standard. Nevertheless, the auditing standards have not effectively dealt with this topic. See the specific comments on the exposure draft entitled Audit Risk and Materiality in Conducting an Audit.

The ASB is missing an opportunity to take advantage of its revision of SAS 39 in its failure to promote the use of statistical sampling. Alone among the professions, public accounting fails to take this obvious step. By giving so-called non statistical sampling equal status with statistical sampling, the profession promotes guesswork over measurement, a stance that has no empirical support. When SAS 39 was issued as a replacement for SAP 54, Statistical Sampling Subcommittee members had hoped that emphasis on such quantitative factors as risk, tolerable misstatement, and projection of results would have led the profession to adopt statistical procedures. What we have observed over the years has been an example of an auditor's corollary to Gresham's Law (bad money drives good out of circulation) -- bad practice drives out good practice if both are given equal status. The reasons for not advocating statistical sampling, which may have had some validity twenty years ago, are little more than excuses today.

Specific Comments

The specific comments are organized by the EDs of the proposed standards. Citations from the EDs are in normal typeface organized with references to paragraph numbers. Our comments are in **bold.**

PROPOSED STATEMENT ON AUDITING STANDARDS AMENDMENT TO STATEMENT ON AUDITING STANDARDS NO. 95, *GENERALLY ACCEPTED AUDITING STANDARDS*

Standards of Field Work

2. A sufficient understanding of ***the entity and its environment, including its*** internal control***,*** is to be obtained to ***assess the risk of material misstatement of the financial statements whether due to error or fraud,*** plan the audit and to ***design*** ~~determine~~ the nature, timing, and extent of ***further audit procedures*** tests to be performed.

Comment:

'Determine' is the better word. What does 'designing' the nature of audit procedures mean? The decision to apply positive versus negative confirmations, for example, is a question of determining which type of confirmation to employ, not of design. How does one 'design' the timing of audit procedures? One determines the timing. Extent is also an issue of determining the extent, not designing it.

PROPOSED STATEMENT ON AUDITING STANDARDS
AUDIT EVIDENCE

Paragraph 7 of the Ed reads:

> 7. Sufficiency is the measure of the quantity of audit evidence. Competence is the measure of the quality of audit evidence, that is, its relevance and its reliability in providing support for, or detecting misstatements in, the classes of transactions, account balances, and disclosures and related assertions. The quantity of audit evidence needed is affected by the risk of misstatement (the greater the risk, the more the audit evidence required) and <u>also by the quality of such audit evidence (the higher the quality, the less the audit evidence required). Accordingly, the sufficiency and competence of audit evidence are interrelated.</u>

Comments:

The underlined text is incorrect. Evidence that is not relevant or not reliable will fail to rise to the level of sufficiency, no matter what quantity is obtained. See, for example, SAS 39's discussion on nonsampling risk.

The foregoing is concern is mitigated somewhat by the subsequent two paragraphs in the ED. Nonetheless, paragraph 9 repeats an old "truism" that is not necessarily true in its first bullet (see below). For example, when one is confirming receivables, the auditor is relying on the effectiveness of the customer's purchases/payables controls, about which the auditor has little or no information.

> 9. The reliability of audit evidence is influenced by its source and by its nature and is dependent on the individual circumstances under which it is obtained. Generalizations about the reliability of various kinds of audit evidence can be made; however, such generalizations are subject to important exceptions. For example, audit evidence obtained from an independent external source may not be reliable if the source is not knowledgeable. While recognizing that exceptions may exist, the following generalizations about the reliability of audit evidence may be useful:
> • Audit evidence is more reliable when it is obtained from independent sources outside the entity.
> • Audit evidence that is generated internally is more reliable when the related controls imposed by the entity are effective.
> • Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).

• Audit evidence is more reliable when it exists in documentary form, whether paper, electronic, or other medium (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
• Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles.

Paragraph 13 should be revised as follows (strikeouts and underlines represent changes):

13. The auditor uses professional judgment in determining the quantity and quality of audit evidence, ~~and thus~~ <u>that is</u>, its sufficiency and competence, to support the audit opinion. Both the individual assertions in financial statements and the overall proposition that the financial statements as a whole are presented fairly, in all material respects, are of such a nature that the auditor is seldom convinced beyond all doubt with respect to the financial statements being audited. In forming the audit opinion, the auditor does not examine all the information available because conclusions can be reached by using sampling approaches. Ordinarily, the auditor finds it necessary to rely on audit evidence that is persuasive rather than conclusive; however, to obtain reasonable assurance, the auditor is not satisfied with audit evidence that is less than persuasive.

Paragraph 14 also poses problems, which we comment on in indented format:

AUDIT PROCEDURES FOR OBTAINING AUDIT EVIDENCE

14. The auditor obtains audit evidence to draw reasonable conclusions on which to base the audit opinion by performing audit procedures to:
.
.
.
b. **Where necessary or where the auditor has determined to do so, test the operating effectiveness of controls in preventing or detecting material misstatements at the assertion level (audit procedures performed for this purpose are referred to as *tests of controls*); and**

This statement creates an unnecessary ambiguity. Under what circumstances is it necessary to test the operating effectiveness of controls, and where does the auditor determine to do so? Can the auditor decide to

specify control risk to be less than 100% without testing controls?

c. **Support assertions or detect material misstatements at the assertion level (audit procedures performed for this purpose are referred to as *substantive procedures* and include tests of details of classes of transactions, account balances, and disclosures, and substantive analytical procedures).**

The term "*substantive* analytical procedures" [emphasis added] appears more than twenty times in the exposure drafts. What is the purpose of "substantive?" Do non substantive analytical procedures exist? If so, what are they? If not, then remove the unnecessary adjective (recall internal control *structure*). The removal of "substantive" from the expression "substantive tests of details" in the revision to SAS 39 makes more peculiar its addition to the expression "analytical procedures."

15. The auditor always performs risk assessment procedures to provide a satisfactory basis for the assessment of risks at the financial statement and assertion levels. Risk assessment procedures by themselves do not provide sufficient competent audit evidence on which to base the audit opinion, however, and are supplemented by further audit procedures in the form of tests of controls and substantive procedures.

Comment:

Tests of controls and substantive procedures <u>are</u> risk assessment procedures. Any other risk assessment procedures should be identified and described.

16. Tests of controls are required where the auditor's risk assessment assumes the operating effectiveness of controls. In particular, the auditor obtains audit evidence about the operating effectiveness of controls where substantive procedures alone do not provide sufficient competent audit evidence.

Comment:

Shouldn't the first sentence refer to '… the auditor's risk <u>preliminary</u> risk assessment.'? The second sentence ["In particular…'] is confusing. Under what circumstance would ' substantive procedures alone…not provide sufficient competent audit evidence'?

<u>Inspection of Tangible Assets</u>

23. Inspection of tangible assets consists of physical examination of the assets.

Comment:

Are not accounts receivable 'tangible' in the accounting sense? How are they to be physically examined? Should not the wording refer instead to 'assets having physical substance'?

Inquiry and Confirmation

25. and 32.

Paragraph 32 defines confirmation to be a specific type of inquiry, but it isn't clear what, if anything [according to the wording presented], distinguishes one from the other. Many auditors view inquiries as attempts to obtain information from within the entity under audit [or from its attorneys], whereas confirmations are strictly information requests from third parties. Paragraph 25 makes this traditional distinction less clear. Why?

3. The concept of materiality recognizes that some matters, either individually or in the aggregate, are important for fair presentation of financial statements in conformity with generally accepted accounting principles, while other matters are not important. In performing the audit, the auditor is concerned with matters that could be material to the financial statements. The auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by errors or fraud, that are not material to the financial statements are detected.

Comment:

The last sentence is problematic when considered in the light of the concept of tolerable misstatement. Perhaps this could be corrected by inserting the word 'aggregate' and changing 'misstatements' to 'misstatement' in order to clarify that all misstatements need to be considered in the aggregate, not simply one by one. Thus,

> **The auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that aggregate misstatement...**

The wording of paragraphs 4, 20 and 24 deal properly with this issue.

Footnote 3: This definition of *audit risk* does not include the risk that the auditor might erroneously conclude that the financial statements are materially misstated. In such a situation, the auditor ordinarily reconsiders or extends audit procedures and requests that management perform specific tasks to reevaluate the appropriateness of the financial statements. These steps ordinarily lead the auditor to the correct conclusion.

Comment:

Perhaps, but this is an unproven assertion. It is also self-serving and misleading, because it is possible that the auditor may believe that he or she has obtained sufficient competent evidential matter to support a decision that misstatement is material, even if that decision is incorrect. In such a case, the auditor would not necessarily reconsider or extend audit procedures.

9. As stated above, the auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements that are not material to the financial statements are detected, whether those misstatements are caused by errors or fraud.

See paragraph 3 comment, above.

14. Audit risk is a function of the risk that the financial statements prepared by management are materially misstated and the risk that the auditor will not detect such material misstatement.

Comment:

This sentence is poorly constructed. Audit risk is not a ' a function of the risk… that the auditor will not detect such material misstatement.' It IS that risk, by definition. We suggest the following wording:

> **Audit risk is the chance that the financial statements prepared by management are materially misstated and the risk that the auditor will not detect such material misstatement.**

.

26. At the account balance, class of transactions, or disclosure level, audit risk (AR) consists of (*a*) the risk (consisting of inherent risk and control risk) that the balance, class, or disclosure and related assertions contain misstatements (whether caused by error or fraud) that could be material to the financial statements when aggregated with misstatements in other balances, classes, or disclosures and (*b*) the risk (detection risk) that the auditor will not detect such misstatements.

Comment:

This is the only paragraph that refers to tolerable misstatement, but only in the context of audit risk. We believe that this guidance is inadequate. Although tolerable misstatement was introduced in, and is confined to, SAS 39, it applies to all account balances, classes of transactions, or disclosure levels. Tolerable misstatement affects auditor determinations regarding all substantive testing, whether by tests of details or by analytical procedures.

Materiality for planning (audit materiality) is a scope determinant for substantive tests of details, as the maximum misstatement allowable for analytical procedures used as primary substantive tests, and as an exposure limit on untested populations. Audit materiality encompasses both expected misstatement and its associated precision. The difference between tolerable error (the upper error limit) and projected error is precision, which is applicable to both tests of details and analytical procedures.

The audit materiality concept is discussed in the proposed revision to SAS 39, in the paragraph renumbered as 17.

"When planning a substantive test the auditor should consider how much monetary misstatement in the related account balance or class of transactions may exist without causing the financial statements to be materially misstated. This maximum monetary misstatement for the balance or class is called tolerable misstatement for the sample. Tolerable misstatement is a planning concept an is related to the auditor's judgment about materiality for planning purposes in such a way that tolerable misstatement combined for the entire audit plan does not exceed those estimates". [Emphasis added]

Comment:

We note that some auditors equate tolerable misstatement to auditing materiality when determined for the audit as a whole. We further note that, where misstatements of opposite algebraic sign are under considerations, tolerable misstatement may exceed materiality.

Tolerable misstatement is a real consideration; but it is also elusive and extremely difficult to put into practice. Nevertheless, having already introduced the concept into the authoritative literature, we believe that the ASB should expand this section to produce more definitive guidance as to how an auditor applies tolerable misstatement in planning and in evaluation of audit procedures, and properly relates it to materiality at the financial statement level.

26. …These components of audit risk may be assessed in quantitative terms, such as percentages (for example, if the auditor believes that pertinent controls would prevent or detect material misstatements about half the time, the auditor would assess this risk as 50 percent), or in nonquantitative terms over a range.

Comment:

The last phrase is unclear. Ranges are quantitative. Perhaps an ordinal scale [for example, low, medium, high] is the intended meaning.

29. *Detection risk* ….arises partly from the fact that the auditor does not examine 100 percent of an account balance or a class of transactions and partly because of other uncertainties. Such other uncertainties arise because an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results.

Comment:

Even though the paragraph goes on to explain ways to mitigate these 'other uncertainties', it appears to consider implicitly that negligence is an appropriate component of audit risk. This can not be even remotely acceptable.

Detection risk can be disaggregated into additional components of tests of details (TD) and substantive analytical procedures (AP).

Comment:

An analytical procedure would be an inappropriate procedure, if the auditor were to determine that relevant controls are ineffective and control risk is high. Garbage in, garbage out.

30. Detection risk relates to the audit procedures and can be changed at the auditor's discretion. Detection risk should bear an inverse relationship to the risk of material misstatement at the assertion level. The greater the risk of material misstatement the auditor believes exists, the less the detection risk that can be accepted. Conversely, the less risk of material misstatement the auditor believes exists, the greater the detection risk that can be accepted. It is not appropriate, however, for an auditor to rely completely on assessments of the risk of material misstatement, including, where relevant, evidence obtained from tests of the operating effectiveness of controls, to the exclusion of performing substantive procedures on material account balances, classes of transactions, and disclosures.

Comment:

Why not state this more explicitly? That is, it is not appropriate for the auditor to set inherent and control risk to be so low that substantive procedures are [ineffective, unlikely to be effective...]

31. The model, AR = IR x CR x AP x TD, expresses ….. The model is not intended to be a mathematical formula including all factors that may influence the assessment of audit risk; however, some auditors find such a model to be useful when planning appropriate risk levels for audit procedures to reduce the auditor's desired audit risk to an appropriate level.

Comment:

What, exactly is meant here? That it is not intended to be a mathematical formula? [It obviously *is* a mathematical formula.] Or that is not intended to include all factors? If the former, the statement is disingenuous and false on its face. If the latter, what are the other factors that might have been included? It should be noted that, as a mathematical formula, the model depends on the risk of each of its component factors being statistically independent. This has been shown not to be the case. [See Kinney, W.R.,Achieved Audit Risk and

the Audit Outcome Space, Auditing, Vol. 8, Suppl., 1989, 67-84. Kinney's article is a somewhat ironic turn. As the academic member of the ASB's Statistical Sampling Subcommittee, which drafted SAS 39, he was the principal author of the audit risk model]

We are also concerned with the continued placement of inherent risk on the right side of the audit risk model formula. Inherent can not, and should not, be a basis for determining what risk level the auditor has achieved. Its proper use is as a consideration for the auditor's determination of the level of audit risk that is appropriate in the circumstances. Other factors equal, a higher level of inherent risk should imply that an auditor needs to achieve a lower audit risk level, the achievement of which will depend entirely on the auditor's control risk assessment and on evidence gathered from substantive procedures.

UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT

There is discussion throughout this document concerning inherent risk. Yet, it is not until paragraph 107 that the term "inherent risk" is even mentioned. Moreover, the ED's recommendations about the auditor's response to the identified risk is more consistent with a view of inherent risk as a consideration for the auditor's determination of the level of audit risk that is appropriate in the circumstances; but it is not a factor that contributes to the attainment of the auditor's specified level of audit risk, as presented in the audit risk model (see the comment on paragraph 31 of Audit Risk and Materiality in Conducting an Audit).

Taken as a key statement on inherent risk and the auditor's appropriate response to inherent risk, this document is far superior to the limited verbiage and trivial examples of paragraph 27 of Audit Risk and Materiality in Conducting an Audit. Accordingly, the ED should be revised to recognize earlier in the document that inherent risk IS a principal subject of this proposed SAS.

The third bullet states, "The auditor….considers the significance and the likelihood of the risk of material misstatement."

Likelihood and risk are synonymous. This usage by the ASB is a variation on the unfortunate earlier revision of SAS 39, which admonishes the auditor to consider the "risk of assessing control risk". Such choices of verbiage do not clarify; they confuse. We suggest the following modification:

> **The auditor….considers the significance and the likelihood of ~~the risk of~~ material misstatement for each identified risk factor.**

The text in paragraphs 7-16 on Risk Assessment Procedures describes procedures that may rise to the level of substantive tests. Under what circumstances may the auditor regard such procedures as providing competent audit evidence regarding account balances or assertions? The ASB should provide guidance, with appropriate reference to the ED entitled Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained.

There is very little in the discussion in paragraphs 93-107 that provides guidance on how specifically an auditor can evaluate the likelihood of misstatement and no linkage to other sections of the standards would provide a basis for that evaluation, whether for either new or continuing clients. A reference to section entitled Risk Assessment Procedures [paragraphs 7 - 16] would be appropriate.

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

10. Certain audit procedures may be more appropriate for some assertions than others. For example, in relation to revenue, tests of controls may be most appropriate in relation to the completeness assertion, whereas substantive procedures may be most appropriate in relation to the occurrence assertion.

Comment:

While we agree with the intent of this paragraph, it is misleading. Certain audit procedures <u>are</u> more appropriate for some assertions than others. The example is meaningless and not an example at all. Give an example of a test of controls that is more appropriate in relation to the completeness assertion than to, say, the existence assertion; but also give an example where the reverse is the case. Do the same for a substantive test. [Some auditors have suggested analytical procedures to test the completeness assertion regarding revenues.]

This paragraph would be an appropriate place to discuss the auditor's consideration of the direction of a test [understatements versus overstatements].

12. For example, if the auditor considers that there is a lower risk that a material misstatement may occur because of the particular characteristics of the class of transactions (that is, the transactions have lower inherent risk), the auditor may determine that substantive analytical procedures alone may provide sufficient competent audit evidence. On the other hand, if the auditor expects that there is a lower risk that a material misstatement may occur because an entity has effective controls and the auditor intends to design the nature, timing, and extent of planned substantive procedures based on the effective operation of those controls, then the auditor performs tests of controls to obtain audit evidence about their operating effectiveness. For example, the risk of misstatement may be considered low for a class of transactions of reasonably uniform, noncomplex characteristics that are routinely processed and controlled by the entity's information system.

Comment:

This paragraph tacitly advocates reliance on inherent risk as a substitute for reliance on internal control. We believe this is poor guidance. Lower inherent risk would not provide a sufficient basis to rely only on analytical substantive procedures. Consider the 'mound of coal' example of AU312.27 (which is retained in the proposed

statement, Audit Risk and Materiality in Conducting an Audit). Although inherent risk as to the existence assertion may be low, because coal is bulky and not easily carted off, one would not know that a mound is 100% coal, and not a layer of coal over a mound of dirt, without testing it by inspection, not unlike a top layer of salad oil floating on a tank full of water (which, of course, did occur in 1963). Analytical procedures focus only on deviations from expectation. They are unreliable if mistatement offsets a deviation. On the other hand, the ability of the auditor to rely on internal controls might provide a basis for reliance on subtantive analytical procedures. The example should be expanded or changed.

18. …increasing the extent of an audit procedure is effective only if the audit procedure itself is relevant to the specific risk; therefore, the nature of the audit procedure is the most important consideration.

Comment:

If the audit procedure itself is NOT relevant to the specific risk, why is the auditor applying it in the first place? The foregoing comment notwithstanding, the audit procedure must also be reliable. Thus, "only if" is incorrect. Moreover, although extent may depend on nature, it is no less important a consideration.

20. Valid conclusions may ordinarily be drawn using sampling approaches. However, if the quantity of selections made from a population is too small, the sampling approach selected is not appropriate to achieve the specific audit objective, or exceptions are not appropriately followed up, there will be an unacceptable risk that the auditor's conclusion based on a sample may be different from the conclusion reached if the entire population was subjected to the same audit procedure. The proposed SAS *Audit Sampling* provides guidance on planning, performing, and evaluating audit samples.

Comment:

There is no discussion of the extent of testing issue regarding statistical verses a non statistical approach. It is a well known and long establish fact, accepted by every other professional discipline that employs sampling techniques, that there is no way of determining objectively the sufficiency of a non statistical sample or of measuring its results. Writing more than forty years ago on the difference between statistical (probability) and non statistical (judgmental) sampling, W. Edwards Deming stated:

> **The special feature of probability sampling is that it permits use of the theory of probability for the computation, from the sample itself, of probability limits of sampling variation in the**

estimate that come from repeated application of the prescribed sampling procedure to the same equal complete coverage.... The theory of probability.... leads to explicit formulas for the expected value of an estimate and for its sampling variation.

Probability sampling is NOT (emphasis in the original) the substantive expert's selection of "representative" or of "typical" cases... Instead, the selection of the sampling units is accomplished by means of a standard tool known as a table of random numbers. When selections are made by judgment, not by the theory of probability, inferences may be made only by judgment, not by the theory of probability.

For an evaluation of the reliability of such a (sample), we must rely on the expert's judgment: we can not use the theory of probability. In contrast, the precision of an estimate made from a probability sample is never in doubt, as the probabilities associated with any given margin of error one estimates by formulas directly from the sample itself (p 31).
Deming, W. E., *Sample Design in Business Research*, John Wiley & Sons,1960.

Other issues exist, which are more appropriate for the revision to SAS 39. Nevertheless, it is past the time for the accounting professional to catch up.

23. When, in accordance with paragraph 108 of the proposed SAS *Assessing Risks*, the auditor has determined that is it not possible or practicable to reduce the risks of material misstatement at the assertion level to an appropriately low level with audit evidence obtained only from substantive procedures, he or she should perform tests of controls to obtain audit evidence about their operating effectiveness.

Comment:

This paragraph permits the auditor to rely entirely on substantive tests without first having tested controls, because it implies that the auditor may decide that is possible and practicable to reduce the risks of material misstatement at the assertion level to an appropriately low level with audit evidence obtained only from substantive procedures. While test of details may be relied upon as substantive tests, the same is not true for analytical procedures, which will not provide a basis for assurance if controls over underlying explanatory data are untested.

30. When responding to the risk assessment, the auditor may design a test of controls to be performed concurrently with a test of details on the same transaction. The objective of

tests of controls is to evaluate whether a control operated effectively. The objective of tests of details is to detect material misstatements in the financial statements. Although these objectives are different, both may be accomplished concurrently through performance of a test of controls and a test of details on the same transaction, also known as a dual-purpose test. For example, the auditor may examine an invoice to determine whether it has been approved and to provide substantive evidence of a transaction. The auditor should carefully consider the design and evaluation of such tests in order to accomplish both objectives.

Comment:

This paragraph should include a warning that an auditor can not reduce BOTH control risk AND detection risk with information from the same test of details.

This paragraph also tinkers unnecessarily with the term "test of details", seemingly restricting that term to a substantive test. The examination of invoices for evidence of approval remains a test of details, albeit for the purpose of testing a control.

44. The higher the assessed risk, the more likely it is that the substantive procedures will be performed close to the period end and the extent of such procedures increases. Further, the higher the assessed risk, the more critical becomes the nature of the substantive procedures. Although the auditor may alter the nature, timing, and extent of substantive procedures when the auditor has performed tests of controls to obtain audit evidence about their operating effectiveness, the auditor's assessment of risk is judgmental and may not be sufficiently precise to identify all risks of material misstatement.

Comment:

This paragraph provides no guidance regarding the effect of higher risk on the nature of audit procedures. Generally, higher risk implies more rigorous procedures (tests of details versus analytical procedures; or, for tests of details, positive versus negative confirmations). It might also be useful to indicate whether testing prior to period end would be acceptable if the relevant assertion's control risk is assessed at maximum.

44. "…. irrespective of the assessed risk of material misstatement, the auditor should perform substantive procedures for each material class of transactions, account balances, and disclosure. [Last sentence]

Comment:

How is this to be applied? Is the use of a financial statement disclosure checklist sufficient to satisfy an audit procedure for disclosure? If

property and equipment is 1] a large balance, 2] is audited in the prior periods for existence, valuation and completeness, and 3] there are no current valuation issues, what would the current year's requirement be? If selling, general, and administrative expenses were one line caption in the financial statement and the risk of misstatement was reclassification within this category for material accounts within the caption, would procedures be mandatory? If so, what procedures would be appropriate? Some discussion of the disaggregating of financial statement categories would be useful; otherwise auditors are driven to auditing adjusted trial balances by this guidance. Perhaps the guidance would be more effective if the discussion centered on financial statement assertions contained in financial statement categories and or line items.

46. "When the approach consists only of substantive procedures…"
"For significant risks, it is not likely that audit evidence obtained from substantive analytical procedures alone will be sufficient."

Comment:

If the approach consists only of substantive procedures (that is, the auditor places no reliance on relevant controls), then analytical procedures should not be the sole basis for an audit decision as to misstatement. Underlying explanatory data can not be presumed to be reliable. Paragraph 49 touches on this issue, which appears to be ignored here.

52. Performing substantive procedures at an interim date potentially increases the risk that misstatements that may exist at the period end are not detected by the auditor. This risk increases as the remaining period is lengthened.

Comment:

The word 'potentially' in the first sentence is inappropriate, as the second sentence demonstrates. It should be deleted.

…the auditor considers such factors as the control environment, relevant controls, the objective of the substantive procedure, the assessed risk of material misstatement, the nature of the class of transactions or account balance and related assertions, and the ability of the auditor to reduce the risk that misstatements that exist at the period end are not detected by performing appropriate substantive procedures or substantive procedures combined with tests of controls to cover the remaining period.

Comment:

What are the considerations? For example, the *nature* of transactions or account balances should be substantially the same for the interim and year-end populations. If not, the risks would significantly change. The text of Paragraph 55 touches on this point, albeit not clearly.

55. This discussion of the use of analytical substantive procedures during the intervening period should be consistent with the guidance stated in the last sentence of paragraph 46 (on which we commented above). It is contradictory as presently written. This paragraph does not mention what may be the most important single factor that would enable the auditor to obtain evidence based solely on analytical procedures in the intervening period--the ability to rely on controls during that period, based on appropriate tests of controls.

56. If misstatements are detected in classes of transactions or account balances at an interim date, the auditor ordinarily modifies the related assessment of risk and the planned nature, timing, or extent of the substantive procedures covering the remaining period that relate to such classes of transactions or account balances, or extends or repeats such audit procedures at the period end.

Comment:

We believe that this statement is too broad. Audit modifications depend very much on the nature and substantiated cause(s) of the misstatements, as well as their projected impact on the financial statements.

59. ….However, increasing the extent of an audit procedure is appropriate only if the audit procedure itself is relevant to the specific risk.

Comment:

It has already been stated that a procedure must be relevant. Is one now to infer that an irrelevant procedure is appropriate as risk of misstatement is lowered? The sentence is superfluous and confusing.

Because the risk of material misstatement takes account of internal control …

Comment:

Risk does not take account of control; it depends on control.

Paragraph 73.

It might also be stated that the absence of a significant deviation in an analytical procedure may not provide persuasive evidence that

material misstatement does not exist. This could be the case if there were an attempt to offset an unfavorable, but true, deviation from expectation to produce numbers that were consistent with that expectation.

74. …the auditor recognizes that a difference between an estimated amount best supported by the audit evidence and the estimated amount included in the financial statements may *be reasonable*…

Comment:

Instead of "be reasonable", we suggest "not be significant", a usage that is more consistent with modern decision-making techniques, but which leaves room for the exercise of judgment as to how great a difference is deemed significant.

Paragraph 78.

Comment:

There is a discussion of "further undetected misstatement" here, we note its conspicuous absence from the discussion on scope in the materiality document.

Paragraph 79.

Comment:

We believe that the client should be involved in the initial evaluation of prior period misstatement. Since there are two methods for doing this evaluation (iron curtain and rollover), the acceptability of these methodologies should be discussed, including an admonition that the method chosen should be applied consistently. It is necessary to avoid inconsistency when an auditor is replaced. The Auditing Standards Board should resolve this long-standing issue.

Paragraph 80.

Comment:

We are concerned that, with sixteen qualitative factors listed, it may not be practicable for an auditor to pass any adjustments. To do so might subject the auditor to criticism and/or liability.

Paragraph 82.

Comment:

The risk of material misstatement can be reduced by recording some or all passed adjustments as well as extending tests or performing additional procedures (as mentioned). For example, if the auditor has a measure of the maximum potential misstatement, then he/she might propose an adjusting entry that would reduce the difference between the maximum and the adjustment to an amount that does not exceed materiality. The viability of such an approach depend on the confidence with which the auditor can measure the maximum potential misstatement.

The Appendix on Assertions and Examples of Substantive Procedures should be changed to relate to receivables, because receivables have broader application to many more entities.

AMENDMENT TO STATEMENT ON AUDITING STANDARDS NO. 39, *AUDIT SAMPLING*

4. Paragraph 20 is renumbered as paragraph 19 and amended to incorporate guidance from paragraph 5 in the Appendix; paragraph 5 is being deleted.

> *19. The auditor planning a statistical sample can use the relationship in paragraph 31 of the proposed SAS* Audit Risk *to assist in planning the allowable risk of incorrect acceptance for a specific test of details. To do so, the auditor selects an acceptable audit risk and subjectively quantifies his or her judgment of the risk of material misstatement (consisting of inherent risk and control risk), and the risk that substantive analytical procedures and other relevant substantive procedures would fail to detect misstatements that could occur in an assertion equal to tolerable misstatement, given that such misstatements occur and are not detected by the entity's controls.*
>
> **Comment:**
>
> **This is dangerous guidance. If misstatements occur and are not detected by the entity's controls, then analytical procedures can not be relied upon. "Garbage in, garbage out" prevails. The new paragraph should be rewritten to incorporate appropriate warnings as to this inherent weakness of analytical procedures.**

The relationships between these independent risks are illustrated in Table 1 of the Appendix.

> **Comment:**
>
> **Although we comment on Table 1 below, we note here that the risks are NOT independent. Any reliability that may be ascribed to an analytical procedure depends on the effectiveness of the controls over the systems that produce the data that form the basis for the expectations against which deviations are measured.**

Table 1

> **Analytical procedures can not be relied upon to the extent suggested in this table. An auditor can, by applying this table, rely entirely on analytical procedures, even though he or she has determined that there is a 50% risk that controls will not prevent or detect material misstatement. This is absurd. It is equally absurd to reduce the effectiveness of tests of details to a coin flip if the auditor considers control risk to be 100%.**