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Public Company Accounting Oversight Board

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Report on

2016 Inspection of Ernst & Young Accountants LLP
(Headquartered in Rotterdam, Kingdom of the Netherlands)

Issued by the

Public Company Accounting Oversight Board

September 28, 2017

THIS IS A PUBLIC VERSION OF A PCAOB INSPECTION REPORT

PORTIONS OF THE COMPLETE REPORT ARE OMITTED FROM THIS DOCUMENT IN ORDER TO COMPLY WITH SECTIONS 104(g)(2) AND 105(b)(5)(A) OF THE SARBANES-OXLEY ACT OF 2002

PCAOB RELEASE NO. 104-2017-176

PCAOB Release No. 104-2017-176

2016 INSPECTION OF ERNST & YOUNG ACCOUNTANTS LLP

Preface

In 2016, the Public Company Accounting Oversight Board ("PCAOB" or "the Board") conducted an inspection of the registered public accounting firm Ernst & Young Accountants LLP ("the Firm") pursuant to the Sarbanes-Oxley Act of 2002 ("the Act").[1]

Inspections are designed and performed to provide a basis for assessing the degree of compliance by a firm with applicable requirements related to issuer audit work. For a description of the procedures the Board's inspectors may perform to fulfill this responsibility, see Part I.C of this report (which also contains additional information concerning PCAOB inspections generally). The inspection included a review of portions of one issuer audit performed by the Firm and the Firm's audit work on two other issuer audit engagements in which it played a role but was not the principal auditor. These reviews were intended to identify whether deficiencies existed in the reviewed audit work, and whether such deficiencies indicated defects or potential defects in the Firm's system of quality control over audit work. In addition, the inspection included a review of policies and procedures related to certain quality control processes of the Firm that could be expected to affect audit quality.

The Board is issuing this report in accordance with the requirements of the Act. The Board is releasing to the public Part I of the report and portions of Part IV of the report. Part IV of the report consists of the Firm's comments, if any, on a draft of the report. If the nonpublic portions of the report discuss criticisms of or potential defects in the firm's system of quality control, those discussions also could eventually be made public, but only to the extent the firm fails to address the criticisms to the Board's satisfaction within 12 months of the issuance of the report. Appendix A presents the text of the paragraphs of the auditing standards that are referenced in Part I.A. in relation to the description of auditing deficiencies there.

Note on this report's citations to auditing standards: On March 31, 2015, the PCAOB adopted a reorganization of its auditing standards using a topical structure and a single, integrated numbering system. See *Reorganization of PCAOB Auditing*

[1] The Board's inspection was conducted in cooperation with The Netherlands Authority for the Financial Markets.

Standards and Related Amendments to PCAOB Standards and Rules, PCAOB Release No. 2015-002 (Mar. 31, 2015). The reorganization became effective as of December 31, 2016. Citations in this report reference the reorganized PCAOB auditing standards.

PROFILE OF THE FIRM[2]

Offices	14 (Alkmaar, Amsterdam, Arnhem, Eindhoven, Groningen, Hengelo, Leeuwarden, Maastricht, Naaldwijk, Rotterdam, The Hague, Utrecht, Venlo, and Zwolle, Kingdom of The Netherlands)
Ownership structure	Limited liability partnership
Partners / professional staff[3]	148 / 2,277
Issuer audit clients	2
Other issuer audits in which the Firm plays a role[4]	49

[2] The information presented here is as understood by the inspection team, generally as of the outset of the inspection, based on the Firm's self-reporting and the inspection team's review of certain information. Additional information, including additional detail on audit reports issued by the Firm, is available in the Firm's filings with the Board, available at http://pcaobus.org/Registration/rasr/Pages/RASR_Search.aspx.

[3] The number of partners and professional staff is provided here as an indication of the size of the Firm, and does not necessarily represent the number of the Firm's professionals who participate in audits of issuers. The number of partners cited above represents the number of individuals with an ownership interest in the Firm.

[4] The number of other issuer audits encompasses audit work performed by the Firm in engagements for which the Firm was not the principal auditor, including audits, if any, in which the Firm plays a substantial role as defined in PCAOB Rule 1001(p)(ii).

Lead partners on issuer audit work[5]	28
Other names used in audit reports	EY; Ernst & Young; and Ernst & Young Accountants

5 The number of lead partners on issuer audit work represents the total number of Firm personnel (not necessarily limited to personnel with an ownership interest) who had primary responsibility for an issuer audit (as defined in AS 1201, *Supervision of the Audit Engagement*) or for the Firm's role in an issuer audit during the twelve-month period preceding the outset of the inspection.

PART I

INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS

Members of the Board's staff ("the inspection team") conducted primary procedures for the inspection from April 11, 2016 to April 22, 2016 and May 9, 2016 to May 20, 2016.[6]

A. Review of Audit Engagements

The inspection procedures included a review of portions of one issuer audit performed by the Firm and the Firm's audit work on two other issuer audit engagements in which it played a role but was not the principal auditor. The inspection team identified matters that it considered to be deficiencies in the performance of the work it reviewed.

The descriptions of the deficiencies in Part I.A of this report include, at the end of the description of each deficiency, references to specific paragraphs of the auditing standards that relate to those deficiencies. The text of those paragraphs is set forth in Appendix A to this report. The references in this sub-Part include only standards that primarily relate to the deficiencies; they do not present a comprehensive list of every auditing standard that applies to the deficiencies. Further, certain broadly applicable aspects of the auditing standards that may be relevant to a deficiency, such as provisions requiring due professional care, including the exercise of professional skepticism; the accumulation of sufficient appropriate audit evidence; and the performance of procedures that address risks, are not included in any references to the auditing standards in this sub-Part, unless the lack of compliance with these standards is the primary reason for the deficiency. These broadly applicable provisions are described in Part I.B of this report.

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[6] For this purpose, "primary procedures" include field work, other review of audit work papers, and the evaluation of the Firm's quality control policies and procedures through review of documentation and interviews of Firm personnel. Primary procedures do not include (1) inspection planning, which is performed prior to primary procedures, and (2) inspection follow-up procedures, wrap-up, analysis of results, and the preparation of the inspection report, which extend beyond the primary procedures.

Certain deficiencies identified were of such significance that it appeared to the inspection team that the Firm, at the time it issued its audit report, had not obtained sufficient appropriate audit evidence to support its opinion that the financial statements were presented fairly, in all material respects, in accordance with the applicable financial reporting framework and/or its opinion about whether the issuer had maintained, in all material respects, effective internal control over financial reporting ("ICFR"). In other words, in this audit, the auditor issued an opinion without satisfying its fundamental obligation to obtain reasonable assurance about whether the financial statements were free of material misstatement and/or the issuer maintained effective ICFR.

The fact that one or more deficiencies in an audit reach this level of significance does not necessarily indicate that the financial statements are materially misstated or that there are undisclosed material weaknesses in ICFR. It is often not possible for the inspection team, based only on the information available from the auditor, to reach a conclusion on those points.

Whether or not associated with a disclosed financial reporting misstatement, an auditor's failure to obtain the reasonable assurance that the auditor is required to obtain is a serious matter. It is a failure to accomplish the essential purpose of the audit, and it means that, based on the audit work performed, the audit opinion should not have been issued.[7]

The audit deficiencies that reached this level of significance are described below.

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[7] Inclusion in an inspection report does not mean that the deficiency remained unaddressed after the inspection team brought it to the Firm's attention. Depending upon the circumstances, compliance with PCAOB standards may require the Firm to perform additional audit procedures, or to inform a client of the need for changes to its financial statements or reporting on internal control, or to take steps to prevent reliance on its previously expressed audit opinions. The Board expects that firms will comply with these standards, and an inspection may include a review of the adequacy of a firm's compliance with these requirements, either with respect to previously identified deficiencies or deficiencies identified during that inspection. Failure by a firm to take appropriate actions, or a firm's misrepresentations in responding to an inspection report, about whether it has taken such actions, could be a basis for Board disciplinary sanctions.

Issuer A

(1) the failure, in an audit of ICFR, to perform sufficient procedures to test the design and operating effectiveness of controls over the existence and valuation of certain financial assets (AS 2201.42, .44, and .48);

(2) the failure to perform sufficient procedures to test the existence and valuation of certain financial assets (AS 2301.11; AS 2310.20; AS 2501.11), including the failure to perform sufficient procedures to extend the audit conclusions from the date of the Firm's interim testing to the end of the year under audit (AS 2301.45); and

(3) the failure to perform sufficient procedures to evaluate the effect of uncorrected misstatements (AS 2810.17).

The inspection team also identified deficiencies in two audits in which the Firm played a role but was not the principal auditor. Certain deficiencies were of such significance that it appeared to the inspection team that the Firm had not obtained sufficient appropriate audit evidence to fulfill the objectives of its role in the audits. The deficiencies that reached this level of significance are described below –

Issuer B

(1) the failure, in connection with the Firm's role in an audit of ICFR, to perform sufficient procedures to test the design and operating effectiveness of controls over the occurrence of revenue (AS 2201.42 and .44);

(2) the failure to perform sufficient procedures to test the occurrence of revenue, including (1) the inadequate performance of substantive analytical procedures (AS 2305.16), and (2) the use of a sample size that was too small due to an unsupported level of reliance on controls resulting from the insufficient testing of ICFR described above (AS 2301.16, .18, and .37; AS 2315.19, .23, and .23A);

(3) the failure to perform sufficient procedures to test the existence of accounts receivable (AS 2310.28); and

(4) the failure, in connection with the Firm's role in an integrated audit of financial statements and ICFR, to perform sufficient procedures to (1) test the design and operating effectiveness of controls over the existence of inventory and (2) to test the existence of inventory (AS 2201.42 and .44; AS 2510.11).

Issuer C

(1) the failure, in connection with the Firm's role in an audit of ICFR, to perform sufficient procedures to test the operating effectiveness of controls over the occurrence of revenue and existence of accounts receivable, including the failure to perform sufficient procedures to extend the audit conclusions from the date of the Firm's interim testing to the end of the year under audit (AS 2201.55 and .56);

(2) the failure to perform sufficient procedures to test the occurrence of revenue and the existence of accounts receivable, including, among other things, (1) the inadequate performance of substantive analytical procedures (AS 2305.05, .20, and .21), (2) the use of a sample size that was too small due to an unsupported level of reliance on controls resulting from the insufficient testing of ICFR described above (AS 2301.16, .18, and .37; AS 2315.19, .23, and .23A), and (3) the insufficient performance of procedures to extend the audit conclusions from the date of the Firm's interim testing to the end of the year under audit (AS 2301.45; AS 2305, .20);

(3) the failure, in connection with the Firm's role in an audit of ICFR, to perform sufficient procedures to test the design and operating effectiveness of controls over the existence and valuation of inventory (AS 2201.34, .39, .42, .44, and .48), including the failure to perform sufficient procedures to extend the audit conclusions from the date of the Firm's interim testing to the end of the year under audit (AS 2201.55 and .56); and

(4) the failure to perform sufficient procedures to test the existence and valuation of inventory (AS 2510.11; AS 2501.11).

B. Auditing Standards

Each deficiency described above could relate to several applicable provisions of the standards that govern the conduct of audit work. The paragraphs of the standards that are cited for each deficiency are those that most directly relate to the deficiency. The deficiencies also relate, however, to other paragraphs of those standards and to other auditing standards, including those concerning due professional care, responses to risk assessments, and audit evidence.

Many audit deficiencies involve a lack of due professional care. Paragraphs .02, .05, and .06 of AS 1015, *Due Professional Care in the Performance of Work*, require the independent auditor to plan and perform his or her work with due professional care and set forth aspects of that requirement. AS 1015, 07-.09 and paragraph .07 of AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*, specify that due professional care requires the exercise of professional skepticism. These standards state that professional skepticism is an attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of audit evidence.

AS 2301,.03, .05, and .08 require the auditor to design and implement audit responses that address the risks of material misstatement, and paragraph .04 of AS 1105, *Audit Evidence*, requires the auditor to plan and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for the audit opinion. Sufficiency is the measure of the quantity of audit evidence, and the quantity needed is affected by the risk of material misstatement (in the audit of financial statements) or the risk associated with the control (in the audit of ICFR) and the quality of the audit evidence obtained. The appropriateness of evidence is measured by its quality; to be appropriate, evidence must be both relevant and reliable in providing support for the related conclusions.

The paragraphs of the standards that are described immediately above are not cited in Part I.A, unless those paragraphs are the most directly related to the relevant deficiency.

B.1. List of Specific Auditing Standards Referenced in Part I.A.

The table below lists the specific auditing standards that are referenced in Part I.A of this report, cross-referenced to the issuer audits for which each standard is cited.

PCAOB Auditing Standards	Issuers
AS 2201, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*	A, B, and C
AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*	A, B, and C
AS 2305, *Substantive Analytical Procedures*	B and C
AS 2310, *The Confirmation Process*	A and B
AS 2315, *Audit Sampling*	B and C
AS 2501, *Auditing Accounting Estimates*	A and C
AS 2510, *Auditing Inventories*	B and C
AS 2810, *Evaluating Audit Results*	A

C. Information Concerning PCAOB Inspections that is Generally Applicable to Triennially Inspected Firms

A Board inspection includes a review of certain portions of selected audit work performed by the inspected firm and a review of certain aspects of the firm's quality control system. The inspections are designed to identify deficiencies in audit work and defects or potential defects in the firm's system of quality control related to the firm's audit work. The focus on deficiencies, defects, and potential defects necessarily carries through to reports on inspections and, accordingly, Board inspection reports are not intended to serve as balanced report cards or overall rating tools. Further, the inclusion in an inspection report of certain deficiencies, defects, and potential defects should not be construed as an indication that the Board has made any determination about other aspects of the inspected firm's systems, policies, procedures, practices, or conduct not included within the report.

C.1. Reviews of Audit Work

Inspections include reviews of portions of selected audits of financial statements and, where applicable, audits of ICFR and the firm's audit work on other issuer audit engagements in which it played a role but was not the principal auditor. For these audits, the inspection team selects certain portions of the audits for inspection, and it reviews the engagement team's work papers and interviews engagement personnel regarding those portions. If the inspection team identifies a potential issue that it is unable to resolve through discussion with the firm and any review of additional work papers or other documentation, the inspection team ordinarily provides the firm with a written comment form on the matter and the firm is allowed the opportunity to provide a written response to the comment form. If the response does not resolve the inspection team's concerns, the matter is considered a deficiency and is evaluated for inclusion in the inspection report.

The inspection team selects the audits, and the specific portions of those audits, that it will review, and the inspected firm is not allowed an opportunity to limit or influence the selections. Audit deficiencies that the inspection team may identify include a firm's failure to identify, or to address appropriately, financial statement misstatements, including failures to comply with disclosure requirements,[8] as well as a firm's failure to perform, or to perform sufficiently, certain necessary audit procedures. An inspection may not involve the review of all of the firm's audit work, nor is it designed to identify every deficiency in the reviewed audits. Accordingly, a Board inspection report should not be understood to provide any assurance that a firm's audit work, or the relevant issuers' financial statements or reporting on ICFR, are free of any deficiencies not specifically described in an inspection report.

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[8] When it comes to the Board's attention that an issuer's financial statements appear not to present fairly, in a material respect, the financial position, results of operations, or cash flows of the issuer in conformity with the applicable financial reporting framework, the Board's practice is to report that information to the Securities and Exchange Commission ("SEC" or "the Commission"), which has jurisdiction to determine proper accounting in issuers' financial statements. Any description in this report of financial statement misstatements or failures to comply with SEC disclosure requirements should not be understood as an indication that the SEC has considered or made any determination regarding these issues unless otherwise expressly stated.

In some cases, the conclusion that a firm did not perform a procedure may be based on the absence of documentation and the absence of persuasive other evidence, even if the firm claimed to have performed the procedure. AS 1215, *Audit Documentation*, provides that, in various circumstances including PCAOB inspections, a firm that has not adequately documented that it performed a procedure, obtained evidence, or reached an appropriate conclusion must demonstrate with persuasive other evidence that it did so, and that oral assertions and explanations alone do not constitute persuasive other evidence. In reaching its conclusions, an inspection team considers whether audit documentation or any other evidence that a firm might provide to the inspection team supports the firm's contention that it performed a procedure, obtained evidence, or reached an appropriate conclusion. In the case of every matter cited in the public portion of a final inspection report, the inspection team has carefully considered any contention by the firm that it did so but just did not document its work, and the inspection team has concluded that the available evidence does not support the contention that the firm sufficiently performed the necessary work.

Identified deficiencies in the audit work that exceed a significance threshold (which is described in Part I.A of the inspection report) are summarized in the public portion of the inspection report.[9]

The Board cautions against extrapolating from the results presented in the public portion of a report to broader conclusions about the frequency of deficiencies throughout the firm's practice. Individual audit engagements and areas of inspection focus are most often selected on a risk-weighted basis and not randomly. Areas of focus vary among selected audit engagements, but often involve audit work on the most difficult or inherently uncertain areas of financial statements. Thus, the audit work is generally selected for inspection based on factors that, in the inspection team's view, heighten the possibility that auditing deficiencies are present, rather than through a process intended to identify a representative sample.

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[9] The discussion in this report of any deficiency observed in a particular audit engagement reflects information reported to the Board by the inspection team and does not reflect any determination by the Board as to whether the Firm has engaged in any conduct for which it could be sanctioned through the Board's disciplinary process. In addition, any references in this report to violations or potential violations of law, rules, or professional standards are not a result of an adversarial adjudicative process and do not constitute conclusive findings for purposes of imposing legal liability.

C.2. Review of a Firm's Quality Control System

QC 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, provides that an auditing firm has a responsibility to ensure that its personnel comply with the applicable professional standards. This standard specifies that a firm's system of quality control should encompass the following elements: (1) independence, integrity, and objectivity; (2) personnel management; (3) acceptance and continuance of issuer audit engagements; (4) engagement performance; and (5) monitoring.

The inspection team's assessment of a firm's quality control system is derived both from the results of its procedures specifically focused on the firm's quality control policies and procedures, and also from inferences that can be drawn from deficiencies in the performance of individual audit engagements. Audit deficiencies, whether alone or when aggregated, may indicate areas where a firm's system has failed to provide reasonable assurance of quality in the performance of audit work. Even deficiencies that do not result in an insufficiently supported audit opinion or a failure to obtain sufficient appropriate audit evidence to fulfill the objectives of its role in an audit may indicate a defect or potential defect in a firm's quality control system.[10] If identified deficiencies, when accumulated and evaluated, indicate defects or potential defects in the firm's system of quality control, the nonpublic portion of this report would include a discussion of those issues. When evaluating whether identified deficiencies in individual audit engagements indicate a defect or potential defect in a firm's system of quality control, the inspection team considers the nature, significance, and frequency of deficiencies;[11] related firm methodology, guidance, and practices; and possible root causes.

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[10] Not every audit deficiency suggests a defect or potential defect in a firm's quality control system, and this report may not discuss every audit deficiency the inspection team identified.

[11] An evaluation of the frequency of a type of deficiency may include consideration of how often the inspection team reviewed audit work that presented the opportunity for similar deficiencies to occur. In some cases, even a type of deficiency that is observed infrequently in a particular inspection may, because of some combination of its nature, its significance, and the frequency with which it has been observed in previous inspections of the firm, be cause for concern about a quality control defect or potential defect.

Inspections also include a review of certain of the firm's practices, policies, and processes related to audit quality, which constitute a part of the firm's quality control system. This review addresses practices, policies, and procedures concerning audit performance and the following eight functional areas (1) tone at the top; (2) practices for partner evaluation, compensation, admission, assignment of responsibilities, and disciplinary actions; (3) independence implications of non-audit services; business ventures, alliances, and arrangements; personal financial interests; and commissions and contingent fees; (4) practices for client acceptance and retention; (5) practices for consultations on accounting, auditing, and SEC matters; (6) the firm's internal inspection program; (7) practices for establishment and communication of audit policies, procedures, and methodologies, including training; and (8) the supervision by the firm's audit engagement teams of the work performed by foreign affiliates.

END OF PART I

PARTS II AND III OF THIS REPORT ARE NONPUBLIC
AND ARE OMITTED FROM THIS PUBLIC DOCUMENT

PART IV

RESPONSE OF THE FIRM TO DRAFT INSPECTION REPORT

Pursuant to section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(a), the Firm provided a written response to a draft of this report. Pursuant to section 104(f) of the Act and PCAOB Rule 4007(b), the Firm's response, minus any portion granted confidential treatment, is attached hereto and made part of this final inspection report.[12]

[12] The Board does not make public any of a firm's comments that address a nonpublic portion of the report unless a firm specifically requests otherwise. In some cases, the result may be that none of a firm's response is made publicly available. In addition, pursuant to section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(b), if a firm requests, and the Board grants, confidential treatment for any of the firm's comments on a draft report, the Board does not include those comments in the final report at all. The Board routinely grants confidential treatment, if requested, for any portion of a firm's response that addresses any point in the draft that the Board omits from, or any inaccurate statement in the draft that the Board corrects in, the final report.

Building a better working world

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CONFIDENTIAL
Ms. Helen A. Munter
Director, Division of Registration and Inspections
Public Company Accounting Oversight Board
1666 K Street, NW
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The Hague, 4 July 2017

Response to the Draft Inspection Report on the 2016 Inspection of
Ernst & Young Accountants LLP

Dear Ms. Munter,

We are pleased to provide our response to the draft inspection report (the Report) from the Public Company Accounting Oversight Board (the Board or PCAOB) pertaining to the 2016 inspection of Ernst & Young Accountants LLP.

Our overriding objective is to make certain that all aspects of our auditing and quality control processes are of the highest quality for the continued benefit of the capital markets in which the public participates and on which they rely. The PCAOB's inspection process assists us in achieving that objective.

We respect the PCAOB's inspection process and understand that judgments are involved in performing audits, as well as in subsequent inspections of those audits. We have thoroughly evaluated all matters described in Part I, *Inspection Procedures and Certain Observations of the Report*, and have taken actions, where appropriate, in accordance with PCAOB standards and our policies. These actions did not change our original audit conclusions, nor did the actions affect our reports on the issuer's financial statements or our reports to the principal auditor with respect to our role in the audit. We have reviewed the remainder of the Report and have no further comments.

We will continue to work with the Director of the Division of Registration and Inspections and her staff over the twelve-month period following the issuance of the final inspection report. We are committed to working with the PCAOB to continue to strengthen our audit quality control system.

We appreciate the opportunity to provide our response to the Report and look forward to continuing to work with the PCAOB on matters of interest to our U.S. SEC issuer auditing practice.

Respectfully submitted,

Yours sincerely,
Ernst & Young Accountants LLP

R.J.W. Lelieveld

APPENDIX A

AUDITING STANDARDS REFERENCED IN PART I

This appendix provides the text of the auditing standard paragraphs that are referenced in Part I.A of this report. Footnotes that are included in this appendix, and any other Notes, are from the original auditing standards that are referenced. While this appendix contains the specific portions of the relevant standards cited with respect to the deficiencies in Part I.A of this report, other portions of the standards (including those described in Part I.B of this report) may provide additional context, descriptions, related requirements, or explanations; the complete standards are available on the PCAOB's website at http://pcaobus.org/STANDARDS/Pages/default.aspx.

<table>
<tr><td colspan="3">AS 2201, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</td></tr>
<tr><td>USING A TOP-DOWN APPROACH</td><td></td><td></td></tr>
<tr><td>Understanding Likely Sources of Misstatement</td><td></td><td></td></tr>
<tr><td>AS 2201.34</td><td>To further understand the likely sources of potential misstatements, and as a part of selecting the controls to test, the auditor should achieve the following objectives –

▪ Understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorized, processed, and recorded;
▪ Verify that the auditor has identified the points within the company's processes at which a misstatement - including a misstatement due to fraud - could arise that, individually or in combination with other misstatements, would be material;
▪ Identify the controls that management has implemented to address these potential misstatements; and
▪ Identify the controls that management has implemented over the prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could</td><td>Issuer C</td></tr>
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AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*		
	result in a material misstatement of the financial statements.	
Selecting Controls to Test		
AS 2201.39	The auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion.	Issuer C
TESTING CONTROLS		
Testing Design Effectiveness		
AS 2201.42	The auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements. Note: A smaller, less complex company might achieve its control objectives in a different manner from a larger, more complex organization. For example, a smaller, less complex company might have fewer employees in the accounting function, limiting opportunities to segregate duties and leading the company to implement alternative controls to achieve its control objectives. In such circumstances, the auditor should evaluate whether those alternative controls are effective.	Issuers A, B, and C
Testing Operating Effectiveness		
AS 2201.44	The auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively. Note: In some situations, particularly in smaller	Issuers A, B, and C

AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*		
	companies, a company might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for a company's financial reporting and associated controls, the auditor may take into account the combined competence of company personnel and other parties that assist with functions related to financial reporting.	
Relationship of Risk to the Evidence to be Obtained		
AS 2201.48	When the auditor identifies deviations from the company's controls, he or she should determine the effect of the deviations on his or her assessment of the risk associated with the control being tested and the evidence to be obtained, as well as on the operating effectiveness of the control. Note: Because effective internal control over financial reporting cannot, and does not, provide absolute assurance of achieving the company's control objectives, an individual control does not necessarily have to operate without any deviation to be considered effective.	Issuers A and C
AS 2201.55	*Roll-Forward Procedures.* When the auditor reports on the effectiveness of controls as of a specific date and obtains evidence about the operating effectiveness of controls at an interim date, he or she should determine what additional evidence concerning the operation of the controls for the remaining period is necessary.	Issuer C
AS 2201.56	The additional evidence that is necessary to update the results of testing from an interim date to the company's year-end depends on the following factors – • The specific control tested prior to the as-of date, including the risks associated with the control and the nature of the control, and the results of those tests; • The sufficiency of the evidence of	Issuer C

AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*		
	effectiveness obtained at an interim date; • The length of the remaining period; and • The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date. Note: In some circumstances, such as when evaluation of the foregoing factors indicates a low risk that the controls are no longer effective during the roll-forward period, inquiry alone might be sufficient as a roll-forward procedure.	
EVALUATING IDENTIFIED DEFICIENCIES		

AS 2301, The Auditor's Responses to Risks of Material Misstatement		
RESPONSES TO SIGNIFICANT RISKS		
AS 2301.11	For significant risks, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed risks. Note: AS 2110 discusses identification of significant risks[10/] and states that fraud risks are significant risks.	Issuer A

Footnote to AS 2301.11

[10/] See AS 2110.71 for factors that the auditor should evaluate in determining which risks are significant risks.

AS 2301, The Auditor's Responses to Risks of Material Misstatement		
Testing Controls		
TESTING CONTROLS IN AN AUDIT OF FINANCIAL STATEMENTS		
AS 2301.16	*Controls to be Tested.* If the auditor plans to assess control risk at less than the maximum by relying on controls,[12/] and the nature, timing, and extent of planned substantive procedures are based on that lower assessment, the auditor must obtain evidence that the controls selected for testing are designed effectively and operated effectively during the entire **period of reliance**.[13/] However, the auditor is not required to assess control risk at less than the maximum for *all* relevant assertions and, for a variety of reasons, the auditor may choose not to do so.	Issuers B and C

Footnote to AS 2301.16

[12/] Reliance on controls that is supported by sufficient and appropriate audit evidence allows the auditor to assess control risk at less than the maximum, which results in a lower assessed risk of material misstatement. In turn, this allows the auditor to modify the nature, timing, and extent of planned substantive procedures.

[13/] Terms defined in Appendix A, Definitions, are set in **boldface type** the first time they appear.

AS 2301.18	*Evidence about the Effectiveness of Controls in the Audit of Financial Statements*. In designing and performing tests of controls for the audit of financial statements, the evidence necessary to support the auditor's control risk assessment depends on the degree of reliance the auditor plans to place on the effectiveness of a control. The auditor should obtain more persuasive audit evidence from tests of controls the greater the reliance the auditor places on the effectiveness of a control. The auditor also should obtain more persuasive evidence about the effectiveness of controls for each relevant assertion for which the audit approach consists primarily of tests of controls, including situations in which substantive procedures alone cannot provide sufficient appropriate audit evidence.	Issuers B and C

AS 2301, The Auditor's Responses to Risks of Material Misstatement		
Substantive Procedures		
AS 2301.37	As the assessed risk of material misstatement increases, the evidence from substantive procedures that the auditor should obtain also increases. The evidence provided by the auditor's substantive procedures depends upon the mix of the nature, timing, and extent of those procedures. Further, for an individual assertion, different combinations of the nature, timing, and extent of testing might provide sufficient appropriate evidence to respond to the assessed risk of material misstatement.	Issuers B and C
TIMING OF SUBSTANTIVE PROCEDURES		
AS 2301.45	When substantive procedures are performed at an interim date, the auditor should cover the remaining period by performing substantive procedures, or substantive procedures combined with tests of controls, that provide a reasonable basis for extending the audit conclusions from the interim date to the period end. Such procedures should include (a) comparing relevant information about the account balance at the interim date with comparable information at the end of the period to identify amounts that appear unusual and investigating such amounts and (b) performing audit procedures to test the remaining period.	Issuers A and C

AS 2305, *Substantive Analytical Procedures*		
AS 2305.05	Analytical procedures involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the auditor's understanding of the client and of the industry in which the client operates. Following are examples of sources of information for developing expectations: a. Financial information for comparable prior period(s) giving consideration to known changes b. Anticipated results—for example, budgets, or forecasts including extrapolations from interim or	Issuer C

AS 2305, *Substantive Analytical Procedures*		
	annual data c. Relationships among elements of financial information within the period d. Information regarding the industry in which the client operates—for example, gross margin information e. Relationships of financial information with relevant nonfinancial information	
Availability and Reliability of Data		
AS 2305.16	Before using the results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information. The auditor obtains assurance from analytical procedures based upon the consistency of the recorded amounts with expectations developed from data derived from other sources. The reliability of the data used to develop the expectations should be appropriate for the desired level of assurance from the analytical procedure. The auditor should assess the reliability of the data by considering the source of the data and the conditions under which it was gathered, as well as other knowledge the auditor may have about the data. The following factors influence the auditor's consideration of the reliability of data for purposes of achieving audit objectives: • Whether the data was obtained from independent sources outside the entity or from sources within the entity • Whether sources within the entity were independent of those who are responsible for the amount being audited • Whether the data was developed under a reliable system with adequate controls • Whether the data was subjected to audit testing in	Issuer B

AS 2305, *Substantive Analytical Procedures*		
	the current or prior year • Whether the expectations were developed using data from a variety of sources	
Investigation and Evaluation of Significant Differences		
AS 2305.20	In planning the analytical procedures as a substantive test, the auditor should consider the amount of difference from the expectation that can be accepted without further investigation. This consideration is influenced primarily by materiality and should be consistent with the level of assurance desired from the procedures. Determination of this amount involves considering the possibility that a combination of misstatements in the specific account balances, or class of transactions, or other balances or classes could aggregate to an unacceptable amount.	Issuer C
AS 2305.21	The auditor should evaluate significant unexpected differences. Reconsidering the methods and factors used in developing the expectation and inquiry of management may assist the auditor in this regard. Management responses, however, should ordinarily be corroborated with other evidential matter. In those cases when an explanation for the difference cannot be obtained, the auditor should obtain sufficient evidence about the assertion by performing other audit procedures to satisfy himself as to whether the difference is a misstatement. In designing such other procedures, the auditor should consider that unexplained differences may indicate an increased risk of material misstatement. (See AS 2810, *Evaluating Audit Results*.)	Issuer C

AS 2310, *The Confirmation Process*		
Performing Confirmation Procedures		
Form of Confirmation Request		
AS 2310.20	The negative form requests the recipient to respond only if he or she disagrees with the information stated on the request. Negative confirmation requests may be used to reduce audit risk to an acceptable level when (*a*) the combined assessed	Issuer A

AS 2310, *The Confirmation Process*		
	level of inherent and control risk is low, (*b*) a large number of small balances is involved, and (*c*) the auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration. For example, in the examination of demand deposit accounts in a financial institution, it may be appropriate for an auditor to include negative confirmation requests with the customers' regular statements when the combined assessed level of inherent and control risk is low and the auditor has no reason to believe that the recipients will not consider the requests. The auditor should consider performing other substantive procedures to supplement the use of negative confirmations.	
AS 2310.28	During the performance of confirmation procedures, the auditor should maintain control over the confirmation requests and responses. Maintaining control [3/] means establishing direct communication between the intended recipient and the auditor to minimize the possibility that the results will be biased because of interception and alteration of the confirmation requests or responses.	Issuers B
Footnote to AS 2310.28 [3/] The need to maintain control does not preclude the use of internal auditors in the confirmation process. AS 2605, *Consideration of the Internal Audit Function*, provides guidance on considering the work of internal auditors and on using internal auditors to provide direct assistance to the auditor.		

AS 2315, *Auditing Sampling*		
Sampling in Substantive Tests of Details		
Planning Samples		
AS 2315.19	The second standard of field work states, "A sufficient understanding of the internal control structure is to be obtained to plan and audit and to determine the nature, timing, and extent of tests to be performed." After assessing and considering the level of inherent and control risks, the auditor performs substantive tests to restrict detection risk to an acceptable level. As the assessed levels of inherent risk, control risk, and detection risk for other substantive procedures directed toward the same specific audit objective decreases, the auditor's allowable	Issuers B and C

AS 2315, *Auditing Sampling*

	risk of incorrect acceptance for the substantive tests of details increases and thus, the smaller the required sample size for the substantive tests of details. For example, if inherent and control risk are assessed at the maximum, and no other substantive tests directed toward the same specific audit objectives are performed, the auditor should allow for a low risk of incorrect acceptance for the substantive tests of details.[3/] Thus, the auditor would select a larger sample size for the tests of details than if he allowed a higher risk of incorrect acceptance.	

Footnote to AS 2315.19

[3/] Reliance on controls that is supported by sufficient and appropriate audit evidence allows the auditor to assess control risk at less than the maximum, which results in a lower assessed risk of material misstatement. In turn, this allows the auditor to modify the nature, timing, and extent of planned substantive procedures.

AS 2315.23	To determine the number of items to be selected in a sample for a particular substantive test of details, the auditor should take into account tolerable misstatement for the population; the allowable risk of incorrect acceptance (based on the assessments of inherent risk, control risk, and the detection risk related to the substantive analytical procedures or other relevant substantive tests); and the characteristics of the population, including the expected size and frequency of misstatements.	Issuers B and C
AS 2315.23A	Table 1 of the Appendix describes the effects of the factors discussed in the preceding paragraph on sample sizes in a statistical or nonstatistical sampling approach. When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or nonstatistical approach is used. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample.	Issuers B and C

AS 2501, *Auditing Accounting Estimates*		
AS 2501.11	Review and test management's process. In many situations, the auditor assesses the reasonableness of an accounting estimate by performing procedures to test the process used by management to make the estimate. The following are procedures the auditor may consider performing when using this approach: a. Identify whether there are controls over the preparation of accounting estimates and supporting data that may be useful in the evaluation. b. Identify the sources of data and factors that management used in forming the assumptions, and consider whether such data and factors are relevant, reliable, and sufficient for the purpose based on information gathered in other audit tests. c. Consider whether there are additional key factors or alternative assumptions about the factors. d. Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data. e. Analyze historical data used in developing the assumptions to assess whether the data is comparable and consistent with data of the period under audit, and consider whether such data is sufficiently reliable for the purpose. f. Consider whether changes in the business or industry may cause other factors to become significant to the assumptions. g. Review available documentation of the assumptions used in developing the accounting estimates and inquire about any other plans, goals, and objectives of the entity, as well as consider their relationship to the assumptions. h. Consider using the work of a specialist regarding certain assumptions (section 336, Using the Work of a Specialist). i. Test the calculations used by management to translate the assumptions and key factors	Issuers A and C

AS 2501, *Auditing Accounting Estimates*		
	into the accounting estimate.	

AS 2510, *Auditing Inventories*		
Inventories		
AS 2510.11	In recent years, some companies have developed inventory controls or methods of determining inventories, including statistical sampling, which are highly effective in determining inventory quantities and which are sufficiently reliable to make unnecessary an annual physical count of each item of inventory. In such circumstances, the independent auditor must satisfy himself that the client's procedures or methods are sufficiently reliable to produce results substantially the same as those which would be obtained by a count of all items each year. The auditor must be present to observe such counts as he deems necessary and must satisfy himself as to the effectiveness of the counting procedures used. If statistical sampling methods are used by the client in the taking of the physical inventory, the auditor must be satisfied that the sampling plan is reasonable and statistically valid, that it has been properly applied, and that the results are reasonable in the circumstances.	Issuers B and C

AS 2810, *Evaluating Audit Results*		
ACCUMULATING AND EVALUATING IDENTIFIED MISSTATEMENTS		
AS 2810.17	*Evaluation of the Effect of Uncorrected Misstatements.* The auditor should evaluate whether uncorrected misstatements are material, individually or in combination with other misstatements. In making this evaluation, the auditor should evaluate the misstatements in relation to the specific accounts and disclosures involved and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors.[7/] (See Appendix B.) Note: In interpreting the federal securities laws, the Supreme Court of the United States has held	Issuer A

AS 2810, *Evaluating Audit Results*		
	that a fact is material if there is "a substantial likelihood that the …fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[8/] As the Supreme Court has noted, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him …."[9/] Note: As a result of the interaction of quantitative and qualitative considerations in materiality judgments, uncorrected misstatements of relatively small amounts could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility[10/] that it could lead to a material contingent liability or a material loss of revenue.[11/] Also, a misstatement made intentionally could be material for qualitative reasons, even if relatively small in amount. Note: If the reevaluation of the established materiality level or levels, as set forth in AS 2105,[12/] results in a lower amount for the materiality level or levels, the auditor should take into account that lower materiality level or levels in the evaluation of uncorrected misstatements.	

Footnotes to AS 2810.17

7/ If the financial statements contain material misstatements, AS 3101, *Reports on Audited Financial Statements*, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AS 3101.35 discusses situations in which the financial statements are materially affected by a departure from the applicable financial reporting framework.

8/ TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

9/ TSC Industries, 426 U.S. at 450.

10/ There is a reasonable possibility of an event, as used in this standard, when the likelihood of

AS 2810, ***Evaluating Audit Results***
the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.
[11/] AS 2405, *Illegal Acts by Clients.*
[12/] AS 2105.11-.12.