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Report on

2017 Inspection of Ernst & Young AG (Headquartered in Basel, Swiss Confederation)

Issued by the

Public Company Accounting Oversight Board

February 7, 2019

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. 104-2019-071

2017 INSPECTION OF ERNST & YOUNG AG

Preface

In 2017, the Public Company Accounting Oversight Board ("PCAOB" or "the Board") conducted an inspection of the registered public accounting firm Ernst & Young AG ("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 reviews of portions of two issuer audits performed by the Firm and the Firm's audit work on one other issuer audit engagement 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 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.

¹ The Board's inspection was conducted in cooperation with the Swiss Federal Audit Oversight Authority.

PROFILE OF THE FIRM²

Offices	11 (Aarau, Basel, Bern, Lausanne, Luzern, Lugano, Petit-Lancy, St. Gallen, Zug, and Zurich, Swiss Confederation)
Ownership structure	Limited liability corporation
Partners / professional staff ³	135 / 1,988
Issuer audit clients	5
Other issuer audits in which the Firm plays a role ⁴	47
Lead partners on issuer audit work ⁵	28
Other names used in audit reports	Ernst & Young Ltd and Ernst & Young SA

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).

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 June 7, 2017 to June 23, 2017 and from July 17, 2017 to July 28, 2017.⁶

A. Review of Audit Engagements

The inspection procedures included reviews of portions of two issuer audits performed by the Firm and the Firm's audit work on one other issuer audit engagement 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 the standards that most directly relate to the deficiencies and do not include all standards that apply 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.

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 conformity 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

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.

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.

Issuer A

- (1) the failure, in an audit of ICFR, to appropriately assess the risk of material misstatement associated with the valuation of certain financial assets (AS 2110.60);
- (2) the failure, in an audit of ICFR, to perform sufficient procedures to identify and test the design and operating effectiveness of controls over the valuation of certain financial assets (AS 2201.39, .42, and .44);

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.

(3) the failure to perform sufficient procedures to test the valuation of certain financial assets, including the use of sample sizes that, due to an unsupported level of reliance on controls resulting from the insufficient testing of ICFR described above, were too small (AS 2301.16, .18, and .37; AS 2315.19, .23, .23A) and the use of sampling with a sample size that was not representative of the entire population (AS 2315.24);

(4) the failure, in an audit of ICFR, to perform sufficient procedures to test the design and operating effectiveness of controls over the occurrence and valuation of revenue (AS 2201.42, and .44); and

(5) the failure, in an audit of ICFR, to perform sufficient procedures to evaluate identified internal control deficiencies to determine whether the deficiencies, individually or in combination with other deficiencies, constituted a material weakness (AS 2201.39, 62, .65, and .68; AS 2301.34).

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. 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 audit for which each standard is cited.

PCAOB Auditing Standards	Issuer
<i>AS 2110, Identifying and Assessing Risks of Material Misstatement</i>	A
<i>AS 2201, An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements</i>	A
<i>AS 2301, The Auditor's Responses to the Risks of Material Misstatement</i>	A
<i>AS 2315, Audit Sampling</i>	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.

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.

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.

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

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.

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 and that response has received careful consideration. 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.



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Mr. George Botic
Acting Director, Division of Registration and Inspections
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Zurich, 5 November 2018

Response to the Draft Inspection Report on the 2017 Inspection of Ernst & Young AG

Dear Mr. Botic,

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 2017 inspection of Ernst & Young AG.

Our overriding objective is to make certain that all aspects of our auditing and quality control processes are of the highest standard 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 issuers' financial statements. We have reviewed the remainder of the Report and have no further comments.

We will continue to work with you and your staff over the twelve-month period following the issuance of the final 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.

Ernst & Young AG

Marcel Stalder
Country Managing Partner Switzerland

Christophe Marclay
General Counsel, Director

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>.¹³

AS 2110, Identifying and Assessing Risks of Material Misstatement		
IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT		
Identifying Significant Accounts and Disclosures and Their Relevant Assertions		
AS 2110.60	<p>To identify significant accounts and disclosures and their relevant assertions in accordance with paragraph .59e, the auditor should evaluate the qualitative and quantitative risk factors related to the financial statement line items and disclosures. Risk factors relevant to the identification of significant accounts and disclosures and their relevant assertions include:</p> <ul style="list-style-type: none"> ▪ Size and composition of the account; ▪ Susceptibility to misstatement due to error or fraud; ▪ Volume of activity, complexity, and homogeneity of the individual transactions processed through the account or reflected in the disclosure; ▪ Nature of the account or disclosure; ▪ Accounting and reporting complexities associated with the account or disclosure; ▪ Exposure to losses in the account; ▪ Possibility of significant contingent liabilities 	Issuer A

¹³ The text presented in this appendix represents the standards as in effect during the applicable audit period.

AS 2110, Identifying and Assessing Risks of Material Misstatement		
	<p>arising from the activities reflected in the account or disclosure;</p> <ul style="list-style-type: none"> ▪ Existence of related party transactions in the account; and ▪ Changes from the prior period in account and disclosure characteristics. 	

AS 2201, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements		
USING A TOP-DOWN APPROACH		
Selecting Controls to Test		
AS 2201.39	<p>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.</p>	Issuer A
TESTING CONTROLS		
Testing Design Effectiveness		
AS 2201.42	<p>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.</p> <p>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.</p>	Issuer A

AS 2201, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements

Testing Operating Effectiveness		
AS 2201.44	<p>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.</p> <p>Note: In some situations, particularly in smaller 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.</p>	Issuer A
EVALUATING IDENTIFIED DEFICIENCIES		
AS 2201.62	<p>The auditor must evaluate the severity of each control deficiency that comes to his or her attention to determine whether the deficiencies, individually or in combination, are material weaknesses as of the date of management's assessment. In planning and performing the audit, however, the auditor is not required to search for deficiencies that, individually or in combination, are less severe than a material weakness.</p>	Issuer A
AS 2201.65	<p>Risk factors affect whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, will result in a misstatement of an account balance or disclosure. The factors include, but are not limited to, the following –</p> <ul style="list-style-type: none"> ▪ The nature of the financial statement accounts, disclosures, and assertions involved; ▪ The susceptibility of the related asset or liability to loss or fraud; ▪ The subjectivity, complexity, or extent of judgment required to determine the amount involved; ▪ The interaction or relationship of the control with other controls, including whether they are interdependent or redundant; 	Issuer A

AS 2201, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements

	<ul style="list-style-type: none"> ▪ The interaction of the deficiencies; and ▪ The possible future consequences of the deficiency. <p>Note: The evaluation of whether a control deficiency presents a reasonable possibility of misstatement can be made without quantifying the probability of occurrence as a specific percentage or range.</p> <p>Note: Multiple control deficiencies that affect the same financial statement account balance or disclosure increase the likelihood of misstatement and may, in combination, constitute a material weakness, even though such deficiencies may individually be less severe. Therefore, the auditor should determine whether individual control deficiencies that affect the same significant account or disclosure, relevant assertion, or component of internal control collectively result in a material weakness.</p>	
AS 2201.68	The auditor should evaluate the effect of compensating controls when determining whether a control deficiency or combination of deficiencies is a material weakness. To have a mitigating effect, the compensating control should operate at a level of precision that would prevent or detect a misstatement that could be material.	Issuer A

AS 2301, The Auditor's Responses to the Risks of Material Misstatement

TESTING CONTROLS		
Testing Controls in an Audit of Financial Statements		
AS 2301.16	<p><i>Controls to be Tested.</i> 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 <i>all</i> relevant assertions and, for a variety of reasons, the auditor may choose not to do so.</p>	Issuer A

AS 2301, The Auditor's Responses to the Risks of Material Misstatement

Footnotes 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	<p><i>Evidence about the Effectiveness of Controls in the Audit of Financial Statements.</i> 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.</p>	Issuer A
Assessing Control Risk		
AS 2301.34	<p>When deficiencies affecting the controls on which the auditor intends to rely are detected, the auditor should evaluate the severity of the deficiencies and the effect on the auditor's control risk assessments. If the auditor plans to rely on controls relating to an assertion but the controls that the auditor tests are ineffective because of control deficiencies, the auditor should:</p> <ol style="list-style-type: none"> a. Perform tests of other controls related to the same assertion as the ineffective controls, or b. Revise the control risk assessment and modify the planned substantive procedures as necessary in light of the increased assessment of risk. <p>Note: AS 2201 establishes requirements for evaluating the severity of a control deficiency and communicating identified control deficiencies to management and the audit committee in an integrated audit. AS 1305, <i>Communications About Control Deficiencies in an Audit of Financial Statements</i>, establishes requirements</p>	Issuer A

AS 2301, The Auditor's Responses to the Risks of Material Misstatement		
	for communicating significant deficiencies and material weaknesses in an audit of financial statements only.	
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.	Issuer A

AS 2315, Audit Sampling		
SAMPLING IN SUBSTANTIVE TESTS OF DETAILS		
Planning Samples		
AS 2315.19	After assessing and considering the levels 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 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 risks 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.	Issuer A

AS 2315, Audit Sampling		
<u>Footnote to AS 2315.19</u>		
<p>³ Some auditors prefer to think of risk levels in quantitative terms. For example, in the circumstances described, an auditor might think in terms of a 5 percent risk of incorrect acceptance for the substantive test of details. Risk levels used in sampling applications in other fields are not necessarily relevant in determining appropriate levels for applications in auditing because an audit includes many interrelated tests and sources of evidence.</p>		
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.	Issuer A
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.	Issuer A
Sample Selection		
AS 2315.24	Sample items should be selected in such a way that the sample can be expected to be representative of the population. Therefore, all items in the population should have an opportunity to be selected. For example, haphazard and random-based selection of items represents two means of obtaining such samples. ⁴	Issuer A
<u>Footnote to AS 2315.24</u>		
<p>⁴ Random-based selection includes, for example, random sampling, stratified random sampling, sampling with probability proportional to size, and systematic sampling (for example, every hundredth item) with one or more random starts.</p>		