

Office of the Secretary  
Public Company Accounting Oversight Board  
1666 K Street, NW  
Washington, DC 20006-2803

1 March 2010

**Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk, and Related Amendments to PCAOB Standards, PCAOB Rulemaking Docket Matter No. 026**

Dear Office of the Secretary:

Ernst & Young LLP (Ernst & Young) is pleased to submit this comment letter to the Public Company Accounting Oversight Board (PCAOB or the Board) in response to the PCAOB's request for comment regarding the repropoed auditing standards related to the auditor's assessment of and response to risk (the repropoed standards).

We support the PCAOB's objective to update its existing interim standards to reflect improvements that firms have made in risk-based audit methodologies and improvements in standards by other standard setters, and believe the repropoed standards will help to improve the framework established by existing PCAOB standards. We concur with the repropoed standards concept that risk assessment, appropriately applied, should underlie the entire audit process, and result in audit procedures that limit audit risk to an appropriately low level.

We commend the Board for the refinements and improvements made to the original proposed standards. We believe that the repropoed standards more appropriately define the requirements for the auditor's assessment of, and response to, risk, and address many of the comments made by us and others on the original proposed standards. However, recognizing that these repropoed standards will serve as the foundation for future standards setting by the PCAOB, we believe that additional modifications would provide further enhancement and clarification of the repropoed standards. We offer a number of overall comments below related to the repropoed standards, particularly related to the improved transparency of the PCAOB standard setting process and the relationship of the repropoed standards to other standard-setters, the importance of convergence in the risk assessment standard area, making the repropoed standards more useable for auditors, amending PCAOB Auditing Standard No. 5, and maintaining a stand-alone fraud standard. We also provide more detail comments on each of the individual repropoed standards in the attachment to this letter.

We would be pleased to discuss any of our comments with members of the PCAOB or its staff.

Sincerely,

A handwritten signature in black ink that reads 'Ernst & Young LLP'.

## **Overall Comments Related to the Reproposed Standards**

### **Improved Transparency of the Standards Setting Process and the Relationship of the PCAOB Standards to Other Auditing Standards**

We fully support the Board's encouragement for improved transparency in its standard-setting process. We agree with Chairman Daniel L. Goelzer's recommendation on 17 December 2009 urging the Board "to continue to explore ways of making its standards-setting – and the thinking that underlies its proposals – more open." We appreciate the Board's second comment period on these reproposed standards and support the discussion of additional revisions to the reproposed standards with the Board's Standing Advisory Group (SAG) before they are finalized as a step in further improving transparency.

We also encourage the PCAOB to participate in joint meetings of the standards setters and work collaboratively with the International Auditing and Assurance Standards Board (IAASB) and the AICPA Auditing Standards Board (ASB) in the development of future standards. This could be accomplished, for example, by having Board members, or staff, participate in joint task forces with the IAASB and the ASB. We believe that such participation would complement the role of the SAG and other forums that currently inform the Board's agenda and standards-setting activities.

The PCAOB's efforts to increase the transparency of its standard setting process, and an increase in ongoing involvement with other standards-setting bodies, would further enhance the effectiveness of all standards-setters; improve the consistency and understanding of auditing standards around the world; eliminate unnecessary differences among the standards; and clarify the rationale for and understanding of the effect of appropriate differences that remain, such as those necessitated by an integrated audit or by legal or regulatory reasons.

### **Importance of Convergence in the Risk Assessment Audit Standard Area**

We acknowledge the Board's efforts to further align with and reduce differences between the PCAOB standards and the corresponding risk assessment standards of the IAASB and the ASB. The comparison in Appendix 10, which outlines the significant differences in requirements between the Board's reproposed standards and those of the corresponding ISAs and SASs, is helpful in understanding and articulating the differences in requirements among the (existing or proposed) standards. However, we are still troubled by the volume and scope of the remaining differences. For example, signaling that a difference exists (between the Board's proposed standards and those of the ASB) in something as fundamental as the *definition of materiality* leads us to wonder whether such direction will enhance overall audit quality in this country and elsewhere. We believe more progress needs to be achieved in reducing the 50 areas of differences (covering 34 pages) outlined in Appendix 10. We understand that some differences will have to exist, but would hope they could be limited to areas that are unique to the audits of issuers. We recommend that the Board work with the IAASB and the ASB and attempt to reduce the remaining differences prior to the standards being issued in final form.

Some of our comments in the attachment to this letter identify additional areas where we believe greater convergence can still be achieved, without jeopardizing the Board's objective to issue standards appropriate for audits of issuers and that are consistent with the Board's statutory mandate to oversee the audit of public companies subject to the securities laws and to protect the interests of investors.

## **PCAOB Standards Setting Process**

The repropose standards demonstrate the Board's efforts to respond to comments made on the original proposed standards and the continued consideration of other standards-setters as evidenced by the improvements made in the repropose standards. We are particularly pleased with the Board's responsiveness to the comments related to the alignment of the proposed standards with PCAOB Auditing Standard No. 5 (AS 5), and other changes to the overall structure of the standards, including adding definitions in an appendix section, as well as the clarifications made to several of the standards' objectives.

We appreciate the insights provided by the Board in the opening release to the repropose standards, and in Appendix 9, as they have been helpful in interpreting the guidance within the repropose standards. The Board's views on the comments received and the basis for determining the enhancements and revisions made to the standards as part of the reproposal process were beneficial and provided for a deeper understanding of the rationale of the Board when drafting these standards. However, given that the release is not ultimately part of the final standard, any interpretive guidance contained within it may not be given the same consideration by auditors. This could result in application by auditors that is inconsistent with the Board's intentions.

For example, the additional clarification and interpretation of the standards that is included only in Appendix 9, such as the discussion of the term "taken into account" as discussed further below would be beneficial for auditors if included within the repropose standards.

We recommend the Board carefully consider the information provided in Appendix 9 and modify the repropose standards as necessary so that the requirements are able to be interpreted consistently with the Board's intentions.

In addition, as stated previously, although the differences between the repropose standards and those of the ISAs and SASs included in Appendix 10 are intended to be helpful to auditors in understanding the intent of the Board, we believe that providing such a high level view of the differences may result in confusion for the auditor and ultimately reduce audit quality. We believe that it is important for the Board to consider providing additional insight into how auditor performance is expected to change as a result of proposed standards. Highlighting the expected changes will assist auditors in better understanding and implementing the requirements. Providing additional comparisons and analyses will allow practitioners to have additional visibility into the Board's thought process in developing the PCAOB standards, and enhance auditors' understanding, implementation, and consistent execution of the standards on all audits they perform.

We therefore recommend that the Board consider, for future proposed standards, providing the following:

- ▶ specific examples of the expected changes to practice,
- ▶ more detailed comparisons to other standard-setters for the public for review, such as matrices comparing individual paragraphs to the ISAs and the SASs,

- ▶ a discussion by the Board highlighting areas where the Board does not believe significant differences will exist even though there may be differences in the terminology used in the proposed standards compared to the terminology used by other standards setters, and
- ▶ a summary outlining the changes from the Board's extant standards as a result of the proposed standards.

We believe that providing these additional items during a proposal process will help improve audit quality by reducing the confusion when trying to understand the intended changes to current practice and assist auditors in meeting the performance expectations of the Board.

### **Making the Standards More Usable for Auditors to Improve Audit Quality**

We acknowledge the Board's efforts to enhance and improve the risk assessment framework through these repropoed standards. This framework is designed to focus the auditor's attention on appropriate risk identification and developing audit responses tailored to those risks.

Recognizing that these seven repropoed standards, once finalized, will serve as the "bedrock for much of the Board's future standards-setting" as stated by PCAOB Acting Chairman Daniel L. Goelzer in his opening remarks on 17 December 2009, we believe it is an appropriate time for the Board to consider codifying these repropoed standards with the existing PCAOB standards so that the structure of the PCAOB auditing standards become more understandable and usable for auditors to follow. Without such codification, the adoption of these repropoed standards will introduce a third style of standards that is inconsistent with the PCAOB's other standards, as well as numerous conforming amendments, without a clear vision for integrating the standards in the future.

We recommend the Board consider reviewing all of the PCAOB auditing standards and redraft, as necessary, proposed and existing standards in a consistent manner, with the intent of promoting greater understanding and making the standards more usable for auditors, which in turn will further the Board's objective of improving audit quality.

We offer the following comments, as well as the additional comments in the attachment to this letter, for the PCAOB to consider.

#### ***Establishment of Clearly Defined Objectives***

We support the Board's use of objectives in the repropoed standards, and acknowledge the Board's efforts in revising the objectives of the repropoed standards so that the objectives have a clear statement of purpose. However, as noted in our previous comment letter, we continue to believe that the Board should consider, from the outset, how objectives are intended to fit into the overall framework of PCAOB standards going forward.

We recommend that the Board consider a standard setting project to redraft existing PCAOB standards and draft future standards in a similar structure as the repropoed standards. We recommend as part of this project that the Board consider establishing an overall objective in each PCAOB standard that is clearly defined. The Board's establishment of clearly defined objectives will assist in the auditor's understanding of how the various aspects of the audit fit into the overall framework of the PCAOB standards.

### ***Clarification of Terms Used in the PCAOB Standards***

The Board's Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards* (Rule 3101), provides guidance to the auditor related to the requirements for certain terminology used in the PCAOB standards such as "should," "must," and "may". Rule 3101 states that the word "should" indicates responsibilities that are presumptively mandatory. Rule 3101 also explains that, if a Board standard provides that the auditor "should consider" an action or procedure, then consideration of the action or procedure is presumptively mandatory while the action or procedure is not. Rule 3101 does not however discuss or provide direction relative to the various other uses of the word "should," such as "should evaluate," "should include," "should take into account," and "should assess" that are used throughout the repropoed standards. The Board provides clarification in Appendix 9 of the release to the repropoed standards when the phrase "take into account" is used, stating that this phrase is "in reference to information or matters that the auditor should think about or give attention to in performing an audit procedure or reaching a conclusion. Accordingly, the results of the auditor's thinking on the relevant matters should be reflected in the performance and documentation of the respective audit procedures performed or conclusion reached."

We recommend the Board include clarifications similar to the one described above for other derivations of the presumptively mandatory "should" that are not currently included in Rule 3101. We believe these clarifications will allow auditors to better understand the PCAOB expectations, and the specific activities to be performed, thereby improving consistency of performance and quality of audits.

### ***Requirements within Notes and Appendices***

While we do not disagree with the Board's use of Notes and Appendices within the repropoed standards to help provide clarification to the guidance within the standards, we do not believe the PCAOB should embed auditor requirements within them. Including requirements in Notes and Appendices makes it more difficult for the auditor to reference back to a requirement and to determine that all requirements are met in the performance of an audit. We recommend that the Board consider "elevating" Notes and Appendices that have embedded mandatory and presumptively mandatory requirements as additional paragraphs within the repropoed standards. We believe this improvement will be beneficial to auditors when applying the guidance within these standards and will help improve overall audit quality by improving the usability of the standards.

We offer additional comments in the attachment to this letter where we have identified instances of requirements in Notes and Appendices for the Board to consider when considering this comment.

### ***Conforming Changes to Auditing Standard No. 5***

We commend the Board for their efforts in revising the repropoed standards to better align with AS 5 and recognize that the risk assessment process is basically the same, regardless of whether the audit is of financial statements only or for an audit of internal control over financial reporting that is integrated with an audit of the financial statements (an integrated audit). The repropoed standards, as revised, more clearly articulate the auditor's responsibility in the risk assessment process, whether the audit is of the financial statements only or an integrated audit. We believe, however, that AS 5 should be amended to remove the aspects of the auditor's risk assessment that relate to a financial statement audit. We believe the auditor should look to the repropoed standards when performing a

risk assessment for a financial statement audit (whether as a standalone audit or as part of an integrated audit) and should refer to AS 5 only for the additional risk assessment requirements that are necessary in order to perform an audit of internal control over financial reporting. While not consistently applied throughout the repropoed standards, the note to paragraph 12 of the repropoed standard, *The Auditor's Responses to the Risks of Material Misstatement*, provides a good example of such a framework when it refers the auditor to AS 5 for requirements the auditor is to follow when addressing assessed fraud risks in the audit of internal control over financial reporting. We recommend that the Board adopt this type of framework throughout the repropoed standards (i.e., referring the auditor to AS 5 for additional requirements that are necessary for audits of internal control), such that AS 5 would only contain these additional requirements.

We recommend that the Board amend AS 5 to remove content that is duplicative of guidance that is included in the repropoed standards. The risk assessment procedures that relate to financial statement audits, whether or not performed as part of an integrated audit, are contained within the repropoed standards and repeating that same guidance within AS5 is confusing for the auditor. By amending AS 5 to eliminate these duplicative risk assessment procedures, the auditor will more easily be able to determine the additional requirements necessary to execute an audit of internal control over financial reporting in connection with an audit of the financial statements. We further believe this will allow for improvement in the execution of audits of internal control over financial reporting.

### **Stand Alone Fraud Standard**

We agree with the Board that the auditor's responsibility for identifying and responding to risk of material misstatement due to fraud ("fraud risks") is an integral part of an audit and should not be a separate consideration. However, we continue to believe that there is benefit to auditors having a single standard that explains the auditor's responsibilities related to fraud. Extant AU 316, *Consideration of Fraud in a Financial Statement Audit* (AU 316), provides an effective framework for gathering information and using that information to better understand, identify and respond to fraud risks. It describes the responsibilities of the auditor throughout all phases of the audit, beginning with understanding fraud and its characteristics and ending with documenting the auditor's consideration of fraud.

We remain concerned that, after reflecting the repropoed conforming amendments, there will no longer be a single place in the auditing standards that presents a complete picture of the auditor's responsibilities related to fraud. We also are concerned about a lack of clarity as to how the remaining requirements in AU 316 link to fraud-related requirements that will now be in other places throughout the repropoed standards. We do not believe that auditor performance will be improved by spreading fraud-related requirements throughout the standards. We believe that additional guidance for auditors on the types of procedures to perform in response to identified fraud risks, along with additional tools and enablers will yield better results in terms of the auditor's ability to detect material financial statement fraud.

Therefore, we recommend that the Board retain AU 316 in its entirety, and include references, as appropriate, to the existing requirements in AU 316 in other sections of the PCAOB auditing standards. This will still allow the Board to achieve its objective of integrating the consideration of fraud in the risk assessment standards, while also keeping a separate standard for the consideration of fraud throughout the audit process.

We note the Board has taken this approach in paragraph 15 of the repropoed standard, *The Auditor's Responses to the Risks of Material Misstatement*, where it references the procedures in AU 316 related to addressing the risk of management override of controls. We recommend that the Board consider this type of referencing back to AU 316 within all of the repropoed standards, resulting in a single fraud standard that appropriately references, and is referenced from, the repropoed risk assessment standards.

### **Effective Date**

We commend the Board for responding to our comment in the original proposed standard and including an effective date in the repropoed standards. As we stated in our previous letter, when determining the final effective date of the repropoed standards, we ask the Board to consider providing sufficient time for firms to incorporate the standards into their respective methodologies and training programs prior to implementation.

### **Other Comments Related to the Repropoed Standards**

We present below our more detailed comments specific to each of the seven repropoed standards and the conforming amendments to the PCAOB standards. To facilitate your review, consistent with our previous letter, we have referenced the detailed comments to the related overall comment in the body of our letter. In some instances, however, a comment does not relate back directly to an overall comment, in which case no reference is provided.

#### ***Appendix 1: Audit Risk in an Audit of Financial Statements***

- ▶ We recommend the following revision to paragraph 1:

This standard discusses the auditor's consideration of audit risk in an audit of financial statements as part of an integrated audit ~~and~~ or an audit of financial statements only.

- ▶ Paragraph 5 defines the risk of material misstatement as the "risk that the financial statements are materially misstated, i.e., the financial statements are not presented fairly in conformity with the applicable financial reporting framework." This definition contrasts the ISA 200 definition of the risk of material misstatement, which says "the risk that the financial statements are materially misstated prior to the audit." The ISA 200 definition makes it clear that the risk of material misstatement is the entity's risk. We believe that this concept is important to include and therefore recommend adding the words "prior to the audit" to the first sentence of paragraph 5. *[Improved Transparency of the Standards Setting Process and the Relationship of the PCAOB Standards to Other Auditing Standards]*
- ▶ The Paragraph 7 definition of inherent risk and control risk, and the paragraph 9 definition of detection risk, each include a statement that the risk is the risk "individually or in combination with other misstatements." The definitions as they currently read may be interpreted by the auditor as a requirement to consider whether the combination of dissimilar risks will result in a material misstatement. In assessing inherent risk and control risk at the assertion level, we believe that the auditor should consider only risks of material misstatement that are related to a particular assertion as opposed to assessing them in combination with other unrelated risks. Therefore, we

recommend the definitions in paragraph 7 and paragraph 9 replace the word “combination” with “aggregate” as this term more clearly indicates the various types of risk that should be considered. The use of “aggregate” in these definitions is also consistent with the way the ISAs and SASs define these terms. *[Improved Transparency of the Standards Setting Process and the Relationship of the PCAOB Standards to Other Auditing Standards]*

- ▶ The repropoed standard in paragraphs 9 and 10 discuss each of the components of the audit risk model including inherent risk, control risk, and detection risk; however, the standard does not link these concepts together. We believe that discussion on the relationship of these concepts is necessary for the auditor to determine the acceptable level of detection risk for the financial statement assertions which is then used to determine the nature, timing and extent of substantive auditing procedures. We therefore recommend the Board include the guidance in AU 319 *Consideration of Internal Control in a Financial Statement Audit* paragraph .81 which states “The auditor uses the assessed level of control risk (together with the assessed level of inherent risk) to determine the acceptable level of detection risk for the financial statement assertions” as the second sentence of paragraph 9 of the repropoed standard in order to appropriately describe the audit risk model.

## ***Appendix 2: Audit Planning and Supervision***

- ▶ The Note to paragraph 6 includes a requirement of the auditor. We recommend the Board consider including guidance in this Note as a separate paragraph in the repropoed standard. *[Requirements within Notes and Appendices]*
- ▶ We recommend the following revisions to paragraph 7 as the matters listed are matters that are important to the *audit* of the company’s financial statements and are matters the auditor typically *considers* in planning an audit engagement but generally would not entail an evaluation. We therefore recommend the following revision to paragraph 7: *[Clarification of Terms Used in PCAOB Standards]*

“the auditor should ~~consider evaluate~~ whether the following matters are important to the audit of the company’s financial statements and internal control over financial reporting and, if so, how they will affect the auditor’s procedures.”

- ▶ It is not appropriate to include the reference to “and internal control over financial reporting” in paragraph 7 as the Board has indicated that these repropoed standards exclude requirements specific to audits of internal control over financial reporting. In addition, the following bullets from paragraph 7 appear to only relate to matters that would be important to an audit of internal control over financial reporting. Therefore, we recommend the Board review these bullets to determine if they are required for audits of financial statements:
  - ▶ The type and extent of available evidence related to the effectiveness of the company’s internal control over financial reporting;
  - ▶ Public information about the company relevant to the evaluation of.... the effectiveness of the company’s internal control over financial reporting;



In addition to considering whether the following matter is important to a financial statement audit, if the Board concludes that this matter is important to a financial statement audit, we believe the following revision is necessary to make it clear that it pertains to the *auditor's judgments*, which is consistent with the bullet point in paragraph 7 related to materiality:

- ▶ *The auditor's* Preliminary judgments about the effectiveness of internal control over financial reporting
- ▶ Paragraph 10a requires the auditor to develop and document the nature, "timing" and extent of risk assessment procedures. We do not believe it is necessary to document the "timing" of such procedures, and we further believe that this would be impractical as risk assessment is an ongoing process that occurs throughout the execution of the audit. Further, the related guidance in AU 311 *Planning an Audit* (Redrafted) (AU 311) paragraph 9 does not include this requirement. We recommend the reference to "timing" within paragraph 10a be removed. [*Improved Transparency of the Standards Setting Process and the Relationship of the PCAOB Standards to Other Auditing Standards*]
- ▶ Paragraphs 11-14 discuss the auditor's responsibilities with respect to multi-location engagements. However, we note that in the release text in Appendix 9 of the repropoed standards, the Board states that the provisions in these paragraphs "are applicable to all multi-location audits, not just group audits." This statement could be interpreted to indicate that the PCAOB intends the requirements in these paragraphs to apply to situations where the principle auditor makes reference to the work of another auditor. We believe that this requirement would cause unnecessary duplication in audit effort without a corresponding increase to audit quality. We recommend the PCAOB clarify its intent with regards to the applicability of these requirements and as necessary modify the requirements within paragraphs 11-14 to reduce any unnecessary duplication of audit efforts. [*PCAOB Standards Setting Process*]
- ▶ Paragraph 14 of this repropoed standard is an example of incorporating unpredictability in a multi-location environment as discussed in paragraph 5 of repropoed standard *The Auditor's Responses to the Risks of Material Misstatement*; however, a presumptively mandatory requirement has been added, which we do not believe is necessary. We do not believe that it is necessary for the standards to prescribe how the auditor should incorporate an element of unpredictability for multi-location audits. Therefore, we suggest that the Board consider removing the presumptively mandatory requirement and, rather, including this as an example within paragraph 5 of the repropoed standard, *The Auditor's Responses to the Risks of Material Misstatement*.

### **Appendix 3: Consideration of Materiality in Planning and Performing an Audit**

- ▶ Paragraph 3 states "it ordinarily is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors." The use of the term "ordinarily" leads the auditor to believe that there are situations in which it would be appropriate to design audit procedures based solely on qualitative factors. We believe that language in AU section 312 *Materiality in Planning and Performing an Audit* (Redrafted) (AU 312) paragraph 6 that states the following "Although it is not practical to design audit procedures to detect misstatements that could be material solely because of their nature (that is, qualitative considerations), the auditor

considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements" would be more appropriate as we do not believe that it is practical to design audit procedures based solely on qualitative factors. *[Improved Transparency of the Standards Setting Process and the Relationship of the PCAOB Standards to Other Auditing Standards]*

- ▶ Paragraph 6 states:

When planning the audit, the auditor should establish a materiality level for the financial statements as a whole that is appropriate in light of the particular circumstances. This includes consideration of the company's earnings and other relevant factors.

We believe that there are certain situations when it is appropriate for the materiality level for the financial statements to be based upon factors other than earnings. In applying this requirement, it may be interpreted by auditors that the established materiality level should always be based upon earnings. Therefore we recommend the Board clarify this requirement.

- ▶ Paragraph 7 requires the auditor to evaluate whether "there are certain accounts or disclosures for which there is a substantial likelihood that misstatements of lesser amounts than the materiality level established for the financial statements as a whole would influence the judgment of a reasonable investor. If so, the auditor should establish separate materiality levels for those accounts or disclosures." We believe that materiality is a concept that should be applied to the financial statements as a whole and not influenced by any particular account or disclosure. Establishing different materiality amounts for different accounts is inconsistent with this concept and could result in a significant level of audit effort being applied at a more granular level and may result in the auditor focusing more efforts on what is material at the account or disclosure level rather than considering what is material to the financial statements as a whole. We believe this would result in what could be virtually never ending effort in evaluating audit differences and whether they are material to the financial statements as a whole. This increase in audit effort in establishing different materiality levels at both the financial statement as a whole and at the account and disclosure level and in evaluating whether audit differences are material at each of these levels at the end of an audit may not result in a commensurate increase in audit quality. In addition, we believe this concept is embedded in the requirement in paragraph 8 that states "the auditor should determine the amount or amounts of tolerable misstatement for purposes of assessing risks of material misstatement and planning and performing audit procedures at the account or disclosure level." This requirement is sufficient to address the risk that misstatements of lesser amounts than materiality established for the financial statements as a whole are appropriately identified when performing the audit. We therefore, recommend the Board remove paragraph 7 from the repropose standard.
- ▶ Paragraphs 8 and 9 use the term "tolerable misstatement," which is also used in AU350 *Audit Sampling* (AU350). However, AU350.18 defines tolerable misstatement for purposes of the sample as the maximum monetary misstatement for the balance or class while the repropose standard requires the auditor to determine the amount or amounts of "tolerable misstatement" for purposes of assessing risks of material misstatement at the account or disclosure level. We believe that using the same term, with different meanings, in the audit sampling guidance and the risk assessment guidance will result in confusion for auditors. We recommend the PCAOB consider

using different terminology in the risk assessment standards, such as “performance materiality.” This term is consistent with the terminology used in ISA 320 paragraph 11 and AU 312 paragraph 11. The use of this term in the repropoed standards would reduce the confusion of having “tolerable misstatement” applied by the auditor in two different contexts. *[Clarification of the Terms Used in the PCAOB Standards]*

#### **Appendix 4: Identifying and Assessing Risks of Material Misstatement**

- ▶ We recommend the Board consider including an additional statement within paragraph 3, the objective of the repropoed standard, which emphasizes that the auditor’s identification and assessment of risks of material misstatements is “through understanding the entity and its environment, including the entity’s internal control.” This language is consistent with ISA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* and would link to the requirements discussed within the repropoed standard in paragraphs 7 and 8. *[Improved Transparency of the Standards Setting Process and the Relationship of the PCAOB Standards to Other Auditing Standards]*

- ▶ The reference in footnote 3 refers to a definition of *fraud* in AU 316. As the Board has integrated aspects of AU 316 into the repropoed standards, we suggest that the Board include this definition of fraud in Appendix A of the repropoed standard and include among its conforming amendments the following change to the last sentence of AU 316.05 to clarify that the term “fraud” as used in the Board’s standards is an act that results in a material misstatement of the financial statements:

For purposes of *PCAOB auditing standards* ~~the section~~, *fraud* is an intentional act that results in material misstatement in the financial statement that are the subject of an audit.

- ▶ Paragraph 7 requires the auditor to “obtain an understanding of the company and its environment (“understanding of the company”) to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement.” Since none of the bullets in paragraph 7 appear to be an “event, condition or company activity”, we ask the Board to provide examples of the types of events, conditions and company activities that might be considered to have a reasonable expectation of having a significant effect on the risks of material misstatement so that the auditor is able to understand the threshold of when such events are considered to have a significant effect on the risks of material misstatement. Alternatively, we suggest that the Board revise paragraph 7 as follows:

“The auditor should obtain an understanding of the company and its environment (“understanding of the company”) to ~~understand the events, conditions and company activities that might be reasonably expected to have a significant effect on~~ assist the auditor in identifying and assessing the risks of material misstatement.”

- ▶ The use of the terms “encompasses” and “includes” in paragraphs 9, 10, and 24 may be confusing for auditors in determining whether the Board meant all of the matters are required to be considered. If this is the intent of the Board, we recommend the Board consider using “should” instead of “encompasses” and “includes” so that the requirements are more clearly understood by the auditor. *[Clarification of Terms Used in PCAOB Standards]*

- ▶ We recommend the following revision to the first note to paragraph 10:

“The size and complexity of a company might affect the risks of material misstatement and how the company addresses those risks.”

We also recommend that the Board review the repropoed standards for other instances where the Board uses “those risks” to define “risks of material misstatement” to ensure that when this shorthand phrase is used, it is clear to the auditor that “those risks” are “risks of material misstatement.”

- ▶ The second Note to paragraph 10 states:

“The auditor should take into account the information gathered while obtaining an understanding of the nature of the company when determining the existence of related parties...”

We recommend the Board consider including the note as a separate paragraph within the standard as there is an embedded requirement contained within the Note that makes it difficult for the auditor to reference and determine that it is appropriately applied. [*Requirements within Notes and Appendices*]

- ▶ The procedures required of the auditor in paragraph 11 appear to be very prescriptive and limiting of the auditor’s ability to apply judgment when determining the appropriate procedures that are necessary to be performed as part of understanding the company, since certain of these procedures may be less relevant for certain public companies (e.g., earnings calls may be less relevant for companies that are not actively followed by analysts) and may be endless for others (e.g., the number of blog sites and other publicly available information for certain companies is virtually endless, such that reading all of such public information may well be impossible and, in some cases, of little value) . We believe that the listed procedures within paragraph 11 would be more appropriate to be referenced as examples of procedures that may be performed to meet the requirements of paragraph 10 and therefore suggest that the Board replace the phrase “should consider” with “may consider” within the first sentence of paragraph 11.
- ▶ We suggest the following revision to paragraph 11 to be consistent with the overall requirement to obtain an understanding of the company and its environment (“understanding the company”) in paragraph 7:

Reading public information about the company relevant to the ~~evaluation of the likelihood of material financial statement~~ identification of risks of material misstatements and the effectiveness of the company’s internal control over financial reporting,

- ▶ Paragraphs 13 and 68 discuss requirements for the auditor to consider the risk of omitted or incomplete disclosures and to identify the necessary disclosures for the company’s financial statements. We recommend that the Board clarify that this evaluation is performed in the context of the disclosures that are required by the company’s financial reporting framework.

- ▶ Paragraph 15 of the repropoed standard provides examples of “which business risks might result in material misstatement of the financial statements.” The examples provided within this paragraph are examples of business risks; however, the examples do not demonstrate how the business risks may result in material misstatements to the financial statements. We recommend the Board consider expanding the examples to demonstrate how these example business risks might reasonably be expected to result in material misstatements. This will allow auditors to better understand the Board’s view of business risks and when they could reasonably be expected to result in material misstatement of the financial statements, so that the execution of these risk assessment procedures are more likely to be consistently applied in all audits.
- ▶ In the second Note to paragraph 20, it is not clear whether a walkthrough would be sufficient to determine whether a control has been implemented. Paragraph 64 seems to imply this as it states that “performing walkthroughs will frequently be the most effective way of achieving the objectives in paragraph 62,” and one of the objectives in paragraph 62 is to “Identify the controls that management has implemented to address these potential misstatements.” Because of this lack of clarity, we recommend the Board clarify that a walkthrough would be sufficient to determine whether a control has been implemented by adding the following sentence to the end of the second Note to paragraph 20:

*Ordinarily, performing walkthroughs as described in paragraphs 64 and 65 are sufficient to determine whether a control has been implemented.*

- ▶ Paragraph 28 requires the auditor to “obtain an understanding of the information system, including the related business processes, relevant to financial reporting.” Paragraph 30 further states that “Obtaining an understanding of the company’s business processes assists the auditor in obtaining an understanding of how transactions are initiated, authorized, processed and recorded.” While there may be some cases in which obtaining an understanding of the business processes may be necessary for the auditor, or may assist the auditor, in obtaining an understanding of how transactions are initiated, authorized, processed and recorded, we believe that in most cases, this understanding can be gained without the need to gain an understanding of the company’s business processes. As a result, we do not believe that obtaining an understanding of the company’s business processes should be required. We do agree that obtaining an understanding of how transactions are initiated, authorized, processed and recorded is necessary to achieve the overall objective of an audit, and believe that gaining an understanding of related business processes may be an example of a way in which to obtain such understanding. We therefore recommend the Board remove the phrase “,including the related business processes,” from paragraph 29 of the repropoed requirement, and modify paragraph 30 to indicate that obtaining an understanding of the company’s business processes “may assist” the auditor in obtaining an understanding of how transactions are initiated, authorized, processed and recorded.
- ▶ Paragraph 33 requires the auditor to obtain an understanding of control activities that is “sufficient to assess the factors that affect the risks of material misstatement.” Currently, the repropoed standards do not establish a framework for evaluating the sufficiency of this understanding. We are concerned that this requirement could be interpreted by the auditor as a requirement to consider all of the company’s control activities regardless of their nexus to financial reporting and to the audit. Such a requirement may result in a significant increase in audit effort for audits of financial statements, where an auditor ordinarily would only be required

to obtain an understanding of controls sufficient to plan the audit, and as a result, may develop an audit strategy that does not rely on a company's control activities. We do not believe that this increase in effort for financial statement only audits corresponds to an increase in audit quality. Paragraph 20 states that obtaining an understanding of internal control includes evaluating controls "that are relevant to the audit," which we believe provides an appropriate framework for determining the appropriate level of understanding. We recommend the Board consider clarifying the requirements in the repropoed standard such that the auditor's responsibility is for understanding the control activities that are relevant to the audit.

- ▶ We recommend the following revision to paragraph 42:

If the ~~engagement partner~~ ~~auditor~~ has obtained other information relevant to identifying risks of material misstatement through other engagements performed for the company, the auditor should take that into account in identifying risks of material misstatement.

The Note to paragraph 56a. should reference paragraphs 66-70 rather than paragraphs 67-70.

- ▶ The Note to paragraph 56c. states:

"the auditor should evaluate how risks at the financial statement level could affect risks of misstatement at the assertion level."

We recommend the Board consider including this requirement as additional discussion within paragraph 56c. [*Requirements within Notes and Appendices*].

We also recommend that the Board review the proposed standards to assure that the word "material" is appropriately placed after the words "risks of" and before the word "misstatement" throughout the proposed standards.

- ▶ Paragraphs 62-64 contain requirements related to understanding likely sources of misstatement. While these are largely consistent with AS 5, in a financial statement audit an auditor may elect not to rely on a company's controls. The requirements in paragraph 62, for example, for the auditor to identify controls that management has implemented go beyond what should be required in a financial statement only audit. We recommend the Board consider whether the requirements to identify all the controls management has implemented to address potential misstatements significantly enhances the auditor's ability to plan and perform a financial statement only audit given the potential increase in costs this identification may require.
- ▶ We recommend the following revision to the second bullet of paragraph 62:  
~~Verify that the auditor has identified~~ *Identify* 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;
- ▶ The reference made in paragraph 66 to the "preceding paragraph" should actually say "earlier in this paragraph" as the illustrative risk factors are discussed within paragraph 66 and not within paragraph 65.

- ▶ We recommend the following revision to paragraph 67:

~~The auditor should not assume that~~ All of the conditions discussed in paragraph 66 ~~must~~ *are not required to* be observed or evident to conclude that a fraud risk exists. The auditor might conclude that a fraud risk exists even when only one of these three conditions is present.

- ▶ We believe the Appendix A definition of significant risk in paragraph A5 should include the concept that a significant risk is based upon those risks that the auditor determines need special audit consideration. Therefore, we recommend the Board consider the following revision to the definition of significant risk which is also consistent with the definition of significant risk in AU 314 and ISA 315:

*An identified and assessed* risk of material misstatement that *the auditor determines* requires special audit consideration.

- ▶ The information included in Appendix B *Consideration of Manual and Automated Systems and Controls* includes several presumptively mandatory requirements that we believe make it difficult for auditors to reference and determine that they are appropriately applied in an audit. We also believe that the content of the appendix is important for auditors to consider during the risk assessment process and therefore recommend the Board incorporate the requirements and guidance in Appendix B within the repropoed standard. [*Requirements within Notes and Appendices*]

#### **Appendix 5: The Auditor's Responses to the Risks of Material Misstatement**

- ▶ In order to align the objective of this repropoed standard with the objectives of the entire suite of repropoed standards (i.e., that the auditor's procedures are designed to be responsive to the assessed risks of material misstatement), we recommend the following revision to paragraphs 1 and 2:

The standard establishes requirements and provides direction regarding designing and implementing appropriate responses to the assessed risks of material misstatement.

The objective of the auditor is to address the assessed risks of material misstatement through appropriate overall responses and audit procedures.

We also recommend that the Board consider changing the title of the proposed standard to add the word "assessed" to the title.

- ▶ The Board discusses in appendix 9, in relation to the overall responses to risk, that paragraph 5c. of this repropoed standard is intended to extend the requirement of incorporating an element of unpredictability into the audit, such that the auditor should incorporate an element of unpredictability as part of the response to the risks of material misstatement including the risk of fraud. We do not believe that the requirements within paragraph 5c. will be applied consistent with this interpretation, unless this interpretive guidance is included within the repropoed standards. Further, we do not believe that it is appropriate or necessary to incorporate an element of

unpredictability to risks other than fraud risks in the audit, as this requirement would increase the audit effort without a corresponding increase in audit quality. Therefore, we recommend that the Board consider incorporating elements of unpredictability in the selection of audit procedures in the context of responding to the risk of material misstatement due to fraud only. *[PCAOB Standards Setting Process]*

- ▶ Paragraph 6 states the following:

The auditor should also evaluate whether it is necessary to make *pervasive* changes to the nature, timing, or extent of audit procedures to adequately address the assessed risks of material misstatement. Examples of such *pervasive* changes include performing substantive procedures at the period end instead of at an interim date; or modifying the nature of audit procedures to obtain more persuasive audit evidence. We note that the original repropoed standard used the term "general" to describe these types of changes. It is unclear why the Board changed the term from 'general' to 'pervasive' and whether there was any intended change to auditor performance. We recommend the Board consider whether a definition of the term "pervasive" is necessary to clarify the point. *[Clarification of Terms Used in PCAOB Standards]*

- ▶ Paragraph 9c. relates to integrated audits only, therefore we recommend the Board include this requirement within AS 5 and not in the repropoed standard as the requirement is not relevant to financial statement only audits. *[Conforming Changes to Auditing Standards No. 5]*
- ▶ The Note to paragraph 23 states:

To obtain evidence about whether a control is effective, the control *must* be tested directly;

This requirement is consistent with AS 5. However, we suggest including additional discussion to clarify the meaning of "tested directly." For example, the Board could consider adding the concept that while the absence of misstatements does not support the effective operation of a control, the absence of misstatements can inform the risk assessment associated with a control and, as such, affect the nature, timing and extent of testing of a control for operating effectiveness. We believe this additional clarification would be helpful to the auditor in better understanding what is meant by "tested directly." *[Clarification of Terms Used in PCAOB Standards]*

We also recommend that the Board consider including this requirement either within paragraph 23 or as a separate paragraph within the repropoed standard in order for the auditor to be able to better identify and refer to the requirement within the repropoed standard. *[Requirements within Notes and Appendices]*

- ▶ The requirements in paragraph 31 under the heading "Using Audit Evidence Obtained in Past Audits" are largely consistent with the requirements of AS 5 paragraphs 47 and 58. However, the requirements as they are included within the repropoed standard could be overly burdensome for the auditor as they could be interpreted as a requirement to evaluate and document the auditor's considerations of all controls tested in connection with the prior year audit. The requirement within AS 5 is intended to provide for the auditor's experience in prior years to inform the current year assessment of risk, which in turn affects the nature, timing and extent of testing necessary.



We believe it is necessary to include these additional considerations from AS 5 paragraphs 47 and 58 in the repropoed standard to better articulate the requirement. *[Conforming Changes to Auditing Standard No. 5]*

- ▶ Paragraph 34 provides the auditor with direction when control deficiencies are detected. The proposed standard however does not provide direction for the auditor when a control deviation occurs. We recommend the Board include the guidance in AS 5 paragraph 48 which provides direction for the auditor when a control deviation is identified. *[Conforming Changes to Auditing Standard No. 5]*
- ▶ We suggest removing the presumptively mandatory requirement from the second sentence of paragraph 45. We believe the requirement in the first sentence provides the appropriate level of direction for the auditor. The detailed procedures to perform should be determined by the auditor based on professional judgment.

#### ***Appendix 6: Evaluating Audit Results***

- ▶ The Note to paragraph 6b. includes a requirement for the auditor to modify the audit procedures or perform additional procedures when there is discovery of a previously unidentified risk of material misstatement.

The second Note to paragraph 17 includes a requirement for the auditor to take into account certain factors when the reassessment of materiality results in a lower amount.

The Note to paragraph 25a. includes a requirement for the auditor to obtain an understanding of the reasons management did not correct audit misstatements.

Due to the importance of each of these requirements, we recommend the Board consider including these notes as separate paragraphs within the repropoed standard. *[Requirements within Notes and Appendices]*

- ▶ Paragraph 15 includes guidance for the auditor to communicate accumulated misstatements to management on a timely basis to provide them with an opportunity to correct them. The original proposed standard also included the requirement for the auditor to request that management correct the misstatements. This requirement has been removed from the repropoed standards. Both ISA 450, *Evaluation of Misstatements Identified during the Audit* and AU 312 paragraphs 7-9, include a requirement for the auditor to understand management's rationale for not recording identified misstatements and the effect on the audit. Requiring the auditor to make a direct request of management to correct misstatements will encourage management to make such corrections in the current period. Therefore, we believe this is an important requirement to retain and recommend the PCAOB include the requirements from ISA 450 within the repropoed standard. *[Improved Transparency of the Standards Setting Process and the Relationship of the PCAOB Standards to Other Auditing Standards]*

- ▶ We recommend the following revision to footnote 11 of paragraph 20:

Misstatements also include omission or incomplete presentation of disclosures.

- ▶ We do not believe that Appendix B *Qualitative Factors Related to the Evaluation of the Materiality of Uncorrected Misstatements* has been referenced within the body of the repropoed standard. We suggest that the Board add such a reference (for example, to paragraph 17) to clarify the intended purpose of the Appendix.
- ▶ Fraud risk was defined in paragraph 4d. of the repropoed standard. Therefore we recommend the following revision to paragraph 26:

Also, the auditor should evaluate whether the auditor's risk assessments, including in particular, the assessment of ~~risks of material misstatement due to fraud~~ risks, and the related audit responses remain appropriate.

- ▶ The Note to paragraph 31 states:

if the financial statements, including accompanying notes, fail to disclose information that is required by the applicable financial reporting framework, the auditor should express a qualified or adverse opinion and should provide the information in the report if practicable, unless its omission from the report is recognized as appropriate by a specific auditing standard.

The description above may lead auditors to believe that it is necessary to disclose information that is not material to the financial statements and if this information is not disclosed then the auditor should express a qualified or adverse opinion. We therefore ask the Board to clarify that there is a materiality threshold for determining the appropriate disclosures in the financial statements.

- ▶ Paragraph 37 relates to audits of internal control over financial reporting only; therefore, we recommend the Board consider removing this from the repropoed standard, consistent with the discussion in Paragraph 1 of Appendix 1 of the repropoed standards, and retaining the concept within AS 5. [*Conforming Changes to Auditing Standard No. 5*]
- ▶ The definition of "misstatement" in paragraph A2 of Appendix A as it is currently drafted implies that the definition is defining "material misstatement" as opposed to "misstatement." We recommend that the Board consider moving the second sentence of the definition that deals simply with "misstatement" to the first sentence of the paragraph and include the following revision:

A misstatement ~~may relate to~~ is a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that should be reported in conformity with the applicable financial reporting framework.

These changes will provide a better understanding for the auditor of what defines a "misstatement" and the implications to the financial statements when misstatements are material.

## Appendix 7: Audit Evidence

- ▶ We recommend the following revision to paragraph 12 to be consistent with the description used in paragraph 62 of the repropoed standard, *Identifying and Assessing Risks of Material Misstatement*:

if the assertions are sufficient for the auditor to identify the types of potential misstatements and to respond appropriately to the risks of material misstatement in each significant account and disclosure that have a reasonable possibility of containing misstatements that would cause the financial statements to be materially misstated, individually or in aggregate with other misstatements.

- ▶ Paragraph 16 discusses the limited nature of audit evidence that can be obtained through the use of observation as an audit procedure, and provides the auditor's observation of inventory counting as an example of an observation. The performance of an inventory observation includes not only performing observations but also making inquiries and inspecting evidence of the existence of inventory, and thus provides considerably more evidence than the type of observation that might provide more limited evidence. Therefore we recommend the Board include an example of performing observations that is something other than performing an inventory observation.

A different example of observation that the PCAOB may consider is the auditor's observation of the presentation of the Chief Financial Officer's explanation of the key variations in the quarterly financial results to the Audit Committee or the auditor's observation of the accounts receivable manager checking the credit limits of a customer prior to processing an order from the customer.

- ▶ The word "written" related to confirmations was deleted from the original proposed standard in paragraph 18. We believe that "written" is important to include within paragraph 18 as it relates to confirmations and without this word it could have effects on the evaluation of information provided from third parties as part of the audit. We therefore recommend the Board consider the following revision to paragraph 18:

A confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party.

- ▶ Paragraph 21 does not include "scanning" as part of analytical procedures. We believe this is an important procedure for the auditor to consider. Therefore, we recommend the Board consider including "scanning" as an analytical procedure and also incorporate the scanning guidance from AU section 326, *Audit Evidence* (Redrafted) paragraph A22 within the repropoed standard. *[Improved Transparency of the Standards Setting Process and the Relationship of the PCAOB Standards to Other Auditing Standards]*

### **Appendix 8: Conforming Amendments**

- ▶ Paragraph 1 of the repropoed standard, *Audit Evidence*, uses the phrase “sufficient appropriate audit evidence.” We note that the Board’s conforming amendments would replace the term “competent” with the term “appropriate” throughout the extant standards. The resulting phrase in many instances is “sufficient appropriate evidential matter.” Audit evidence is defined in the repropoed standards; however, “evidential matter” is not. Therefore, we believe that the conforming amendments should be revised to replace the phrase “sufficient competent evidential matter” with “sufficient appropriate audit evidence” to be consistent with the phrase used in the repropoed standard, *Audit Evidence*.
- ▶ Appendix 9 states that AU sections 350.23 to 350.38 have been amended to explain more specifically how the principles in the standard apply for determining sample sizes when nonstatistical sampling approaches are used. To this end, appendix 8 proposes to add paragraph .23A and to add a sentence to the end of paragraph .38 of AU section 350, *Audit Sampling*, which includes the following:

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.

We believe that this addition to AU section 350 may lead auditors to infer that it is necessary to calculate sample sizes using both statistical and nonstatistical approaches, in all circumstances, in order to be in a position to be able to compare the sample sizes. We suggest that the PCAOB remove the phrase “or larger than” from the second sentence in the proposed sentence and add footnote 5 from the ASB’s revised AU section 350.23 to clarify that is not the intent.

- ▶ The conforming amendment to AS 3 paragraph 9 adds additional documentation requirements for the auditor to document risk assessment procedures and responses to risk of misstatement that “include (1) a summary of the identified risks of [material] misstatement and the auditor’s assessment of risks of material misstatement at the financial statement and assertions levels and (2) the auditor’s responses to the risks of material misstatement, including linkage of the responses to those risks.” We believe these additional documentation requirements will result in an unnecessary linkage and a matrix- like mentality to documentation that will not improve audit quality but will likely increase the cost of performing audits.

In addition to reconsidering these documentation requirements, we also recommend the Board consider adding additional documentation requirements within the repropoed standards where the PCAOB believes special documentation considerations, beyond the requirements of AS3, are warranted. This approach is also consistent with the ISAs and SASs approach to establishing documentation requirements for the auditor.

► Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements (AS 5)

We recommend the following conforming amendments to AS 5. [*Conforming Changes to Auditing Standard No. 5*]

- a. Delete paragraphs and Notes 28, 29,30, 36, and 38 (guidance included in corresponding paragraphs 56e, 57, 59,60, 63, 65 of repropoed standard *Identifying and Assessing Risks of Material Misstatement*)
- b. Delete footnote 13 (guidance included in footnote 28 of the repropoed standard *Identifying and Assessing Risks of Material Misstatement*)
- c. Delete the guidance in paragraph 33 and replace with the following sentence:  
  
After applying the guidance within paragraph 61 of repropoed standard *Identifying and Assessing Risks of Material Misstatement* refer to the direction in Appendix B for multiple location scoping decisions.
- d. Delete the first 2 bullets included within paragraph 34 and include a footnote reference within paragraph 34 to repropoed standard *Identifying and Assessing Risks of Material Misstatement* paragraph 62 so that the auditor applies the guidance in AS 5 in combination with paragraph 34 of the repropoed standard for integrated audits.
- e. Delete paragraphs 42, 43,45, 49, 50, and 51 (guidance included in corresponding paragraphs 19, 20,22, 23, 24, and 25 of repropoed standard *The Auditor's Responses to Risks of Material Misstatement*)
- f. Delete paragraph 44 and include the related note as part of the guidance included in repropoed standard *The Auditor's Responses to Risks of Material Misstatement* paragraph 21.
- g. Delete paragraph 47 and incorporate the related notes within paragraph 31 of the repropoed standard *The Auditor's Responses to Risks of Material Misstatement*
- h. Delete bullets from 47 and 58 that are included within the repropoed standard *The Auditor's Responses to Risks of Material Misstatement* paragraph 31