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

Dear Board Members and Staff:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's ("Board" or "PCAOB") *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk, and Conforming Amendments to PCAOB Standards*. We support the Board's objective to update the auditing standards regarding risk assessment. As a member of the Center for Audit Quality (CAQ), we participated in the development of the CAQ's letter of comment in response to the Board's proposed risk assessment standards. We support the comments in the CAQ's letter and therefore, we have minimized repeating the same comments herein. We respectfully submit our comments and recommendations below.

#### **Convergence of auditing standards**

We were pleased to see that the Board considered the work of other standards setters in these proposals, and we found the analysis of significant differences in requirements between the Board's proposed standards and those of the corresponding International Standards on Auditing (ISA) to be very helpful. However, with the elimination of the application and other explanatory material and the various changes in terminology, we believe the Board has introduced inefficiencies into the process of understanding and applying the standards of the PCAOB, making it more difficult for an auditor to perform an effective and efficient audit under PCAOB standards, particularly with respect to multi-location engagements with foreign subsidiaries.

Within the Release, the Board states "Rather than including a significant amount of application material in the proposed standards, the Board reviewed the application and other material in the ISAs, adapted those provisions that the Board believed are necessary for audits of issuers, and included them in the proposed standards themselves." Under the ISAs, the application and other explanatory material is deemed to be essential in understanding the objectives and the proper application of the requirements. We believe this to be true. As we were reviewing the proposed standards, in some circumstances, our understanding of the requirements was based

on our knowledge of the related application material in the ISAs. Although we agree with the Board's assessment that the concepts underpinning the proposed standards should be familiar to most auditors, we also believe PCAOB standards should be autonomous.

In addition, whenever two boards choose different words to address the same concepts, auditors need to consider whether the boards' intents are different, or only the words are different. Where the Board changed the active requirement (such as should consider to should assess), auditors need to understand whether the Board intends the auditor's responsibilities and actions, including those related to documentation, to be different than those under the ISAs. Accordingly, the Board's intent should be either clearly indicated in the analysis of significant differences or explained with additional guidance in the proposed standards.

However, we believe the Board should thoroughly consider the feasibility of taking an entirely different approach to its standard-setting process. Because the PCAOB is an active observer and participant in the International Auditing and Assurance Standards Board's (IAASB) standard-setting process, we believe the PCAOB should adopt the ISAs as a base. In doing so, PCAOB standards can be focused on the incremental requirements that would be necessary for audits of issuers.

This approach has been adopted by the U.S. Government Accountability Office for audits performed under *Government Auditing Standards*, and we believe it is a suitable approach for the PCAOB. Not only will this approach ensure consistency with the ISAs and convergence with other standard setters, it will allow the Board to focus its attention on establishing standards based on issues specifically related to issuers, in lieu of adapting provisions and modifying terminology. By leveraging the resources of other standards setters, we also believe the approach will allow the PCAOB to set standards more timely. Finally, although we believe the comments of the PCAOB observer are taken quite seriously at the IAASB, the PCAOB observer's comments would have even more credibility. This might increase the influence of the PCAOB at the IAASB, resulting in PCAOB standards requiring fewer amendments, greater convergence between the two sets of standards, and the elimination of inefficiencies from the processes of setting, understanding, and applying the standards.

#### Alignment of the proposals with Auditing Standard 5

We understand that one goal of this proposal is to improve the risk assessment process to enhance integration of the audit of the financial statements with the audit of internal control over financial reporting. We recognize that certain foundational risk assessment principles from Auditing Standard (AS) 5, *An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements*, were included in the proposal. However, we believe the delineation of these principles in both AS 5 and the proposed risk assessment standards has introduced some inconsistencies and redundancies. For example, the proposal inappropriately excludes the role of risk assessment, scaling the audit, and using a top-down approach, which are currently described in AS 5 and are applicable to all audits. Other examples of these types of matters are provided in the CAQ letter.

We believe it would be beneficial to have one standard (or set of standards) dealing with the risk assessment process that is the same for all audits (integrated and financial statement only), and another standard focusing only on the additional requirements in an integrated audit that are specific to achieving the objectives related to the audit of internal control over financial reporting. This structure would (1) more clearly demonstrate the integration of the risk assessment process in an integrated audit, and (2) reduce inconsistencies and redundancies within PCAOB standards. Accordingly, we believe AS 5 requires significant amendment to reflect the risk assessment standards for the Board's proposal to be successful.

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

In reference to our previous comments on aligning the proposed standards with AS 5, we believe proposed *Audit Risk in an Audit of Financial Statements* (Appendix 1) should incorporate the risk assessment concepts in AS 5.

The objective of the auditor in this standard “to conduct the audit of the financial statements in a manner that reduces audit risk to an appropriately low level” relates to the overall objective of the auditor and is not specific to the subject of this standard, which is the auditor's consideration of risk assessments. Furthermore, this standard does not propose any requirements that would enable the auditor to meet the objective. In fact, the only “should” in the standard is in the context of a reference to a requirement that is set in another standard. The Board could take one of several approaches to aligning the requirements and the objective of this standard:

- Revise this standard along the lines of ISA 200 (Revised and Redrafted), *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing* including the objective as the overall objective of the auditor and including a discussion of the relationship between that objective and the objectives in each of the standards. This is the approach we support.
- Incorporate the discussion of audit risk in Appendix 1 of the proposed standard as introductory material to proposed *Identifying and Assessing the Risks of Material Misstatement*.
- Publish the content of Appendix 1 as background material to the standards as a whole, without an objective or requirements.

#### Appendix 2: Audit Planning and Supervision

With respect to proposed *Audit Planning and Supervision*, we have the following observations in addition to those in the CAQ letter:

- In paragraph 6b, we suggest the Board include a reference to Rule 3526, *Communication with Audit Committees Concerning Independence*, as this Rule is important with respect to compliance with independence and ethics requirements.
- Although we understand the intent of the second sentence in paragraph 17, some may interpret it to mean that obtaining sufficient appropriate evidence regarding opening balances is optional. We suggest the Board restructure this paragraph similar to paragraph

A21 of ISA 300, *Planning an Audit of Financial Statements*. At a minimum, we believe the sentence should be split to separate the requirement from the example.

In reference to the Board's questions, we do not believe additional direction is needed with respect to multi-location engagements. However, we are concerned with having similar guidance, covering the same topic, in two places within the body of the standards. Since most of the multi-location guidance in AS 5 also applies in an audit of financial statements, we suggest incorporating the guidance from AS 5 into this proposed standard. In AS 5, we suggest a reference to the guidance in the proposed standard and, if appropriate, additional guidance that is specific to the internal control audit, including how the auditor should use that guidance in combination with the guidance in the proposed standard.

### Appendix 3: Identifying and Assessing Risks of Material Misstatement

We believe proposed *Identifying and Assessing Risks of Material Misstatement* contains certain inconsistencies with AS 5; for example, as mentioned above, the role of risk assessment and scaling the audit (AS 5, paragraphs 10-13) and using a top-down approach (AS 5, paragraph 21) are inappropriately excluded from the risk assessment standards. Such inconsistencies may cause the auditor to diverge from an integrated audit approach because they suggest different, rather than incremental responsibilities. This supports our previous comment to amend AS 5 and incorporate the relevant concepts in the risk assessment standards.

We also have the following additional observations:

- The objective in the proposed standard is not outcome based. It simply states the auditor's objective is it to identify and appropriately assess risks, without including the purpose for which this is to be performed. Under the ISAs, the identification and assessment of risks provides a basis for designing and implementing responses to the assessed risks.
- Paragraph 24 could be rewritten to more clearly state that management may use an internal control framework that differs from the components identified in paragraph 23 when establishing and maintaining the company's internal control over financial reporting. In evaluating the design of controls and determining whether they have been implemented in a financial statement only audit, the auditor may use the framework used by management or another suitable, recognized framework.
- In paragraph 56f, the phrase "without regard to the effect of controls" can be deleted, as the definition of inherent risk in paragraph 7 of Appendix 1 includes this concept in the phrase "before consideration of any related controls." In other words, the phrase is redundant with the definition of inherent risk.
- The proposal lacks guidance on how to identify and assess the risks of material misstatement at the financial statement level. We suggest the Board include additional guidance similar to that included in paragraphs A98-A101 of ISA 315 (Redrafted), *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment*.

In reference to the Board's questions, specific requirements and direction on documentation are not necessary. The Board's standards should remain principles based. Equivalent requirements in comparison to the ISAs would be acceptable.

#### Appendix 4: The Auditor's Responses to the Risks of Material Misstatement

Overall, we believe proposed *The Auditor's Responses to the Risks of Material Misstatement* clearly describes the auditor's responsibilities in response to risks of material misstatement, and we have no additional comments other than those expressed in the CAQ letter.

#### Appendix 5: Evaluating Audit Results

Proposed *Evaluating Audit Results* is a conglomeration of various requirements pertaining to the evaluation of audit results. Although we believe it is appropriate to include such requirements in one standard, the objectives of the auditor would need to address each of the specific objectives that would have been included if the requirements were in separate standards. In this regard, we believe the PCAOB has created a standard that may be perceived as weaker than the ISAs.

In addition, we believe the PCAOB has also made requirements that were quite clear under the ISAs ambiguous under PCAOB standards. More specifically, we provide the following observations that are, for the most part, addressed in more detail by the CAQ letter:

- It should be clear that analytical procedures in the overall review of the financial statements are similar to analytical procedures performed as risk assessment procedures (paragraph 8). This would clarify the fact that the results of such analytical procedures may identify a previously unrecognized risk of material misstatement requiring revision of the auditor's risk assessment and modification of further planned audit procedures.
- There are several different phrases used to describe unusual or unexpected trends, transactions, amounts and relationships that should be reconsidered (paragraphs 7, 9-11). We believe the Board should use the same phrase to describe this set of factors wherever it is referred to.
- The term identified misstatements is inappropriately used (paragraph 14). We believe this term intends to include known or factual misstatements. However, the auditor may identify such misstatements, as well as potential or likely misstatements. Clear delineation is needed with respect to known or factual and potential or likely misstatements.
- The requirement to evaluate uncorrected misstatements related to the prior year does not appropriately reflect Staff Accounting Bulletin (SAB) 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (paragraph 19). The ISAs were written to be framework neutral on this point; however, we believe PCAOB standards should appropriately reflect the requirements in this SAB. However, the ISAs are clearer in that misstatements detected in the current year could be related to the prior year.
- Additional guidance on the indicators of management bias and their effect on the audit, and the auditor's responsibility to assess bias is necessary (paragraphs 25 and 29). Although these

requirements stem from requirements in the ISAs, we believe this is an audit area that requires additional context. The Board should consider incorporating the guidance in paragraphs A1 to A3 of ISA 700, *Forming an Opinion and Reporting on Financial Statements*

- The requirement pertaining to differences in accounting estimates is inadequate as it relates to determining whether a misstatement exists (paragraph 28). The requirement itself seems to relate to whether a misstatement exists in an accounting estimate and does not seem to belong in the section entitled “Assessing Bias in Accounting Estimates.” We believe this requirement should be included in the section entitled “Accumulating and Evaluating Identified Misstatements.” We also believe additional guidance is needed with respect to the difference between point estimates and ranges of estimates (paragraphs A116 to A119 of ISA 540 (Revised and Redrafted), *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*).

#### Appendix 6: Consideration of Materiality in Planning and Performing an Audit

Except with respect to the use of the terms “reasonable investor” and “tolerable misstatement,” we believe proposed *Consideration of Materiality in Planning and Performing an Audit* is clear regarding the auditor’s responsibility to apply the concept of materiality in planning and performing an audit, including establishing lower materiality levels for particular accounts or disclosures. We believe the Board should:

- Reconsider the use of the term reasonable investor. This term is inconsistent with existing PCAOB standards (AS 5, paragraph 91) and ISA 320 (Revised and Redrafted), *Materiality in Planning and Performing an Audit* (paragraph 10), which use the term “user.” We believe the term user is more appropriate when discussing materiality.
- Use the term performance materiality in lieu of tolerable misstatement to be consistent with the ISAs (ISA 320, paragraph 12). In the ISAs, tolerable misstatement is limited to audit sampling and is separately defined. We believe unnecessary differences in terms used by different standards setters to describe the same concepts should be eliminated.

#### Appendix 7: Audit Evidence

For the most part, we believe proposed *Audit Evidence* clearly describes the principles necessary for evaluating the sufficiency, relevance, and reliability of audit evidence. However, the standard itself establishes requirements and provides direction with respect to designing and performing audit procedures to obtain sufficient appropriate audit evidence. To achieve the objective in this proposed standard, which seems to relate to audit evidence obtained during the entire audit, the Board would need to establish requirements similar to those in ISA 200. Essentially, this objective is a requirement in ISA 200 that is necessary to achieve the overall objectives of the auditor. In this regard, the Board should align the objective with the objective in ISA 500 (Redrafted), *Audit Evidence*. We believe this would be consistent with the scope of the proposed standard described in paragraph 1.

We further believe the five categories of assertions are sufficient and do not need to be expanded. However, we also see no need to diverge from the ISAs. In addition, paragraph 12 implies that different assertions could be used based on whether the auditor is performing a

financial statement only audit or an integrated audit. We believe the assertions in both cases would be the same, as is the auditor's risk assessment. What differs is the auditor's procedures to achieve the objectives of a financial statement only audit or an integrated audit. Again, this would also require revision of AS 5.

We would be pleased to discuss our comments with you. If you have any questions, please contact Mr. John L. Archambault, National Managing Partner of Professional Standards, at (312) 602-8701.

Sincerely,

