

PCAOB
Office of the Secretary
Keith Wilson, Associate Chief Auditor
1666 K Street NW Washington DC
202-207-9100 comments@pcaobus.org

Re : The Auditor's Risk Assessment and Responsibility for Risk
Docket : 26
By : Dr. Joseph S. Maresca CPA, CISA

Colleagues,

Thank you for the opportunity to critique the Auditor's Risk Assessment and Responsibility for Risk.

GENERALLY, the Statement seeks to articulate risk. i.e.

- o the risk of expressing an inappropriate opinion when financial statements are materially mis-stated
- o the risk to the entire audit due to material error et al. which the auditor fails to detect
- o what could go wrong on the assertion level
- o do the standards address the risk of fraud or material mis-statement

AUDIT PLANNING AND EVALUATION OF AUDIT RESULTS

CRITIQUE

The auditor must plan for the "what could go wrong" scenario so that there are no surprises. Many things could go wrong in the arena of the auditee; namely,

- o Key personnel could retire/resign leaving a significant learning curve with the attendant errors, downtime and the need for extensive training.
- o Various Acts of G-d could necessitate the operation of the disaster recovery plan and/or contingency plans to restore operability.
- o Host country expropriation could disturb the valuation process materially.
- o The reversal of derivative risk could trigger major contingent liabilities which may be unanticipated or unfunded to date.
- o The "VIX" index level could be higher than usual resulting in significant market gyrations

The "Comprehensive Approach" reviews both internal and external factors in the environment surrounding the auditor. The objective of the auditor is to keep audit risk to a low level for planning and audit supervision purposes. [p. 9/173] In addition, the auditor must evaluate uncorrected mis-statements and control deficiencies in areas like recording transactions and the management of cash. The auditor may encounter problems in evaluating cash management when transactions are driven by computer algorithms. In these cases, the auditor must become familiar enough with the parameters of the computer program in order to understand the financial consequences of the automated cash management decision-making.

The audit process involves evidence - gathering and interpretation. The evidence may consist of a review of documents i.e. Letters of Credit , the testimony of management or experts i.e. derivative exposures and real evidence like inventorying , physical counts of gold bars ... Ultimately, the auditor seeks to keep risks to a low level by exercising due professional care in the conduct of the audit. This task may be difficult in the review of transactions like derivatives since some transactions are bundled to transfer risk and others involve timing differences.

Inherent risk specifies the types of accounts , balances and contingencies susceptible to material mis-statement. The reversibility of derivative transaction risk is one of these areas. The way to guard against this type of error is for the legal counsel to draw up "air tight" contracts with respect to derivative transactions; such that, the rights, duties, obligations and remedies are set forth unequivocally.

The Sixth Circuit Court of Appeals interpreted the duties imposed on banks that market derivatives . After due consideration, the Court rejected a duty of appropriateness. The Opinion reinforces a basic tenet of the over-the-counter derivative markets. That is, swaps are principal to principal transactions so that end users have the responsibility for obtaining their own independent advisors to assist in evaluating proposed transactions. In essence, the Court said "Let the buyer beware ! "

Power and Telephone entered into interest rate swap agreements (rather loosely construed) in 1999 and 2000 with Sun Trust fixing a portion of the variable rate indebtedness. The swaps were favorable to Power and Telephone until interest rates dropped significantly during 2000- 2002. Power and Telephone's borrowing needs reduced and the company unwound the swaps in 2003. Power and Telephone filed a complaint against Sun Trust seeking millions in damages and asserting claims based on theories of breach of contract, agency, misrepresentation, negligence and a whole host of other assertions too numerous to list here.

Power and Telephone Supply Co. v. Sun Trust Banks, 2006
App. LEXIS 12087, 2006 FED APP. 166P (6th Circuit TENN. 2006)

Planning is an iterative process subject to considerable refinement at the beginning of the audit. Planning may consist of risk assessment procedures, substantive testing and other procedures iteratively. Auditing may occur at multiple locations so that the verification is tempered by security risks like Acts of G-d. A classic example is outsourcing in an area where there are ruinous contingencies like floods, Tsunamis, earthquakes etc. Although the arithmetic compilation of financial transactions may be correct and verifiable, other contingencies exist to disturb the current applicability of the audit findings or the reconstruction of business operations after a critical event.

Occasionally, experts in various disciplines may be engaged to opine on what constitutes real values in today's markets. For instance, an expert may be engaged to verify provable reserves for oil drilling purposes. New technologies exist to help structure decision-making where there is significant complexity and variable interpretation of the data.

Artificial intelligence systems are designed to optimize "advice giving" by a community of experts. The knowledge engineer elicits the advice from a well-defined community of experts in the art and places the comparative data on a knowledge base for future analysis and rule-making. Credit scoring is an area where "advice giving" systems may be useful optimally because the knowledge engineer seeks to establish the fairest mix of conditions precedent in order to make practical lending decisions based upon the collective experience of many experts .

Supervision is discussed on P. 25/173. A liaison is needed between the auditor and the Independent Audit Committee of the Board of Directors. The legal counsel must be engaged to explain host country legal issues outside of the auditor's domain of expertise. Examples of such areas are:

- o host country venues for Courts to interpret the rights, duties and liabilities of the parties
- o expropriation risk
- o volatility of local markets , currencies and bourses
- o comity principles
- o the interpretation of major vendor contracts i.e. data processing, disaster recovery etc.

P. 35/173 should refer to the design of controls.

P. 37/173 discusses the IT Audit. The Statement should make reference to IT Security, record - retention of key data and files and contingency planning and testing of the plan.

P. 40/173 Artificial intelligence systems and advice giving systems should be referenced in order to obtain a comprehensive knowledge base for use by the entire client organization.

P. 62,3 should reference change control management to protect the integrity of the existing systems.

Dr. Joseph S. Maresca CPA, CISA