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Office of the Secretary  
PCAOB  
1666 K Street  
N.W.  
Washington  
D. C. 20006-2803.

By email: [comments@pcaobus.org](mailto:comments@pcaobus.org)

*PCAOB Rulemaking Docket No. 026*

Dear Sir

**PCAOB RELEASE NO 2009 - 007: PROPOSED AUDITING STANDARDS RELATED TO THE AUDITOR'S ASSESSMENT OF AND RESPONSE TO RISK AND RELATED AMENDMENTS TO PCAOB STANDARDS**

The ICAEW welcomes the opportunity to comment on the PCAOB's re-proposed auditing standards on risk assessment and consequential conforming amendments published in December 2009.

The ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the ICAEW provides leadership and practical support to over 134,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The ICAEW is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

Our comments have been prepared with the help of many of our members working around the world who have detailed knowledge and practical experience of US, EU and other regulatory regimes. We have not sought to answer the PCAOB's specific questions but instead provide main and detailed comments resulting from our discussions. We hope that this approach is of value to the PCAOB.

We congratulate the PCAOB on an improved set of proposed standards, its decision to re-expose them, and an improved, albeit incomplete, statement of the differences between PCAOB standards and ISAs. The PCAOB has a duty to protect US investors and an absolute right to set whatever standards it considers appropriate in order to achieve this. But it also has a responsibility to engage with standard-setters internationally in the interests of audit quality and for reasons of self-interest. This means convergence in both directions: convergence of international standards with PCAOB standards as well as the other way round.

The PCAOB can and should influence international standard-setting more effectively than it does at present. The ICAEW has a strong interest in the continued improvement of ISAs and the PCAOB is in an ideal position to act as a catalyst for this. Some differences between PCAOB standards and ISAs are inevitable in order to address specific US requirements. While Appendix 10 is helpful to a degree, it often simply notes the differences, or states that they are important, or notes similarities without explaining why the same terminology cannot be used. It does not state whether the differences are necessary to address specific US requirements, nor does it detail those elements of ISAs that are not reflected in PCAOB standards or the rationale for their exclusion (such as the possibility of the combined assessment of inherent and control risk).

These standards are of fundamental importance because so many other standards are built on the same foundations. Going the extra mile on quality and convergence on this occasion will pay dividends because the opportunity to revise these standards is unlikely to arise again soon; we therefore encourage the PCAOB to do so. A majority of responses to the original proposals were strongly in favour of further elimination of differences between PCAOB standards and ISAs. We struggle to see the benefit of many of the differences the PCAOB is proposing to retain and we have doubts as to the extent to which such differences will drive significant changes in behaviour or improvements in audit quality. Wherever possible we believe minor differences in detail between the PCAOB's standards and ISAs should be eliminated. Including minor differences is likely to result in either extensive form filling exercises that contribute little to an effective audit, or substantial overlap of closely related areas for compliance purposes leading to a loss of focus on more important areas. Attempts may also be made to exploit such differences in vexatious litigation.

Audit quality is as much, probably more, about the quality of monitoring, oversight and the right sort of enforcement, as it is about fine details in standards. However, convergence of auditing standards offers significant benefits in terms of consistency and high quality in audits of entities with operations in multiple countries. Large and mid-tier firms around the world, particularly members of the Forum of Firms, use ISAs as the basis for their core methodologies which promotes audit quality because it facilitates training and education of staff and enhances the consistency and effectiveness of multi-national audits. Where substantive differences remain, a comprehensive description of the differences between PCAOB standards and ISAs is essential to ensure that any incremental procedures required by PCAOB standards are effectively executed.

These standards aside, we are pleased to note the PCAOB's growing mindfulness of the importance of convergence. A strategic goal supported by a detailed roadmap is the right way to achieve convergence and we encourage the PCAOB to consider the possibility of this carefully in the light of:

- its own ambitious standard-setting plans;
- the convergence with ISAs of many other standard-setters, including the AICPA and others in North America; and
- the emerging problems associated with developing standards without some sort of framework or objective, such as inconsistent styles of standard which are difficult to apply consistently or update.

Going forward, it will be enormously helpful to the international standard-setting process if the PCAOB can be crystal clear about which areas of PCAOB standards it believes to be technically better than ISAs, and why. The PCAOB should challenge the IAASB in areas in which it believes ISAs can and should be improved. These standards are the place to start.

In order to be clear about differences and changes, the following analyses are needed:

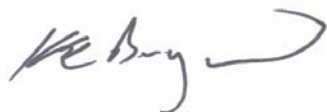
- a mark-up of the original proposal which would better illustrate the revisions made;
- cross-references of the explanations of the changes made between Appendix 9 to the revised proposals;
- a description of the significant changes in practice that the PCAOB anticipates as a result of the revised standards; and
- a description of the significant differences that the PCAOB believes exist between the proposed standards and ISAs (and ASB standards).

We also encourage the PCAOB to consider the need for a final exposure. This is by no means unprecedented. The IAASB recently exposed its standard on group audits three times, considering it to be of critical importance, and it developed its risk standards over a period of almost three years. We do not suggest extending the process for the sake of it, but we believe that getting it right first time in this area will result in a better quality corpus of PCAOB standards, and more influence internationally, in years to come.

Main and detailed comments are set out below.

Please contact me should you wish to discuss any of the points raised in this response.

Yours sincerely



Katharine E Bagshaw FCA  
Manager, Auditing Standards  
ICAEW Audit and Assurance Faculty  
T + 44 (0)20 7920 8708  
F + 44 (0)20 7920 8754  
E: [kbagshaw@icaew.com](mailto:kbagshaw@icaew.com)

## MAIN COMMENTS

### Proposed implementation date

Notwithstanding our comments above about the need for careful consideration of further re-exposure, the proposed implementation date for audits of fiscal years beginning on or after 15 December 2010 seems workable provided that the standards are approved by the SEC by mid-2010. Should this timetable slip, the effective date would need to be revised.

### Drafting

#### Foundational principles

We note that neither foundational principles nor any system for developing objectives is apparent in the re-exposed standards. We have made the same comments in the past to the IAASB and we hope that going forward, both the PCAOB and the IAASB will consider these issues critically in the light of experience.

#### The structure of the standards

The style of the re-proposed standards is different to extant standards. Structure matters and there are many more notes in these standards than in others, and within these there are requirements. Similar considerations apply to appendices. We fear that notwithstanding PCAOB statements as to status, questions will arise as to the relative importance of requirements in standards, the notes, and appendices that may well lead to extended debates with counsel and others. If there is no difference in the status of requirements, why have notes and appendices? We recommend that the PCAOB consider the relatively simple solution to this problem adopted by the IAASB, which has mandatory requirements in one part of the standard (not in notes), and no requirements in application material or appendices. We note that a number of mandatory requirements in the PCAOB standards appear as application material in the ISAs which may add further weight to inappropriate attempts to distinguish between categories of requirements.

#### Terminology and definitions

The PCAOB has chosen to retain some formulations that are not aligned with ISAs, particularly in the context of materiality. The use of the old term 'tolerable misstatement' stands out. The fact that the concept is understood by auditors is not of itself a reason for not changing it and the PCAOB should at least consider the rationale for the change in ISAs. The fact that the term is used in the context of sampling does not mean that it is appropriate to use it in the context of the overall risk assessment.

It would be helpful for the PCAOB to highlight terminology and definitions that are not aligned with ISAs which (in its view) represent *no* significant difference to the terminology and definitions used by the IAASB. We also hope that the PCAOB will seek to advance the case for differences (such as the preference for 'appropriately low level' over 'acceptably low level' in the context of risk reduction) to the IAASB when the subject is next considered.

### Substantive issues

#### Significant risks, fraud, and judgement

We are encouraged by the additional focus on fraud but remain concerned that auditors may inadvertently be encouraged to do too much. Paragraph 53 of the proposed standard *Identifying and Assessing Risks of Material Misstatement* Appendix 3 paragraph 52(d), describes the procedures the auditor should perform for specific inquires about fraud, whereas ISA 240 permits the use of judgement. In that context, we note the point made on page A9-4 of the Additional Discussion about the PCAOB's hesitation in making references to judgement in selected portions of standards, because it may imply that the auditor should not use judgement elsewhere. Even if this misinterpretation were likely (and we would hope that that most auditors are not so rigid and unthinking as to assume that judgement is prohibited unless permitted) we believe it better to state

in the standards that judgement is required in fulfilling all requirements, and that there is a particular need for the exercise of judgement in certain areas, as noted in the standards.

### **Case law in auditing standards**

We do not contest the rationale for the inclusion of references to a 'reasonable investor' in the re-proposed standard on materiality. However, we do not think it necessary to make this reference, and draw the PCAOB's attention to the fact that the issue of materiality has been considered by the courts in many jurisdictions and that auditing and accounting standard-setters in those jurisdictions have not found it necessary to make references to specific court cases in standards, relying instead on their own knowledge and experience, and those of others, nationally and internationally, to formulate a definition of materiality for audit purposes. Furthermore, we believe it inadvisable to use case law in auditing standards and urge the PCAOB to consider carefully whether this is a helpful precedent to set. Case law changes, one case affect the nuances of another and in a relatively short space of time, the reference can be outdated. Auditing standards are not legal documents and while references to statutes and regulation are acceptable, we believe that references to case law are less helpful. We suggest as a minimum that the reference to the specific case be taken out of the main body of the standard and included either in a footnote or an appendix.

## DETAILED COMMENTS

### Audit Risk in an Audit of Financial Statements

1. We remain concerned about the unqualified assertion in paragraph 9 that detection risk is reduced by substantive procedures. We do not contest this assertion, but it is incomplete. We see no acknowledgement here or in the surrounding material, which we agree has been improved, that 'procedures performed by the auditor', which reduce detection risk, include tests of controls, to the extent that the results of such tests will affect the nature and extent of substantive procedures. The implication is that tests of controls are irrelevant to detection risk (reducing the risk of the audit failing to detect that a material misstatement exists) and we do not believe that this is what the PCAOB intends. A statement to the effect that substantive testing is likely to be more important in the presence of heightened detection risk might be more appropriate.
2. The new material in paragraphs 13 and 68 on disclosures might be put into context with a reference to the disclosure requirements of the relevant financial reporting framework.

### Audit Planning and Supervision

3. We are pleased to note that the material now in paragraphs 16 *et seq* deals with the issue of specialists generally and not just IT specialists.
4. We note again that the original paragraph 21 requirement regarding processes for disagreements and documentation thereof has been moved in part to AS 3, but we are concerned that the requirement for the engagement partner and team to be aware of how disagreements should be dealt with has gone, and we do not agree that evidence of compliance with this would be difficult to provide. Disagreements are a sensitive area and it is important that staff are aware of how they should be dealt with. It is possible however, that this requirement belongs in a standard on quality control rather than audit planning and supervision.

### Identifying and Assessing Risk of Material Misstatement

5. We remain concerned that paragraph 71 continues to assert that all fraud risks are significant risks. We believe that this will lead to over-auditing in immaterial areas. There are many very low level fraud risks which are relatively insignificant. ISA 240 requires fraud risks to be treated as significant risks but the significant risks under ISAs are those risks **that the auditor considers** require special audit consideration. We suggest that the PCAOB definition of significant risks be amended to take in this element of judgement.
6. The new material in paragraph 7 on smaller entities is helpful but it is important to recognise that smaller entities can be complex, and larger ones sometimes simple. The former is more of an issue, because complexity rather than size is likely to heighten risk.

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

7. The new material on walkthroughs needs to clearly distinguish walkthroughs for the purposes of testing design effectiveness, and walkthroughs for the purposes of testing operating effectiveness. Paragraph 20 deals with walkthroughs used for assessing design effectiveness which does not really belong in this standard as it is a risk assessment procedure rather than a response.

### Evaluating Audit Results

8. We remain of the view that it is not clear what the additional procedures might be, or what 'determine' means in the note to paragraph 14 (b). It is more likely that the auditor will tell the client to book the adjustment; more work is not always the answer.

### **Consideration of Materiality in Planning and Performing an Audit**

9. The change in paragraph 6 from materiality levels being appropriate in the light of 'surrounding' circumstances to 'particular' circumstances is hardly an improvement. Neither word is necessary.

### **Audit Evidence**

10. The difference between the wording of the objective in paragraph 3 (the objective of the auditor is to plan and perform the audit to obtain appropriate audit evidence that is sufficient to support the opinion expressed in the auditor's report) and the wording in paragraph 4 (the auditor must design and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for his or her opinion) remains unhelpful.
11. The requirement to modify or perform additional procedures in cases of suspect authenticity in paragraph 9 still needs a link to professional scepticism, and further circumscription. Many modifications are routine and to treat them as suspect may create inappropriate expectations.