

February 18, 2009

Office of the Secretary  
PCAOB  
1666 K Street, N.W.  
Washington, DC 20006-2803 USA

Response e-mailed to comments@pcaobus.org

RE: Proposed Auditing Standards Related to the Auditor's Assessment of and  
Response to Risk

Dear Sir/Madam:

The Institute of Internal Auditors (IIA) welcomes the opportunity to respond to the PCAOB's proposed auditing standards related to the auditor's assessment of and response to risk. Our comments are based on a thorough analysis and discussion, utilizing a core team of audit experts who serve on the Institute of Internal Auditors' Professional Issues Committee.

We commend the PCAOB for examining standards to:

- Determine where improvements could be made in view of improved risk-based audit methodologies;
- Serve as an improved foundation for future standard-setting;
- Enhance integration of the audit of financial statements with the audit of internal control over financial reporting; and
- Emphasize the auditor's responsibilities for considering the risk of fraud during the audit.

The following are our principal comments and observations. Detailed response to the questions posed in the exposure document, and other matters related to specific standards, can be found in Attachment A.

Overall, we believe that certain deficiencies in the old standards have not been fully addressed in these revisions. The draft PCAOB revisions could better address developments or other advances in audit methodology that have occurred in the past several decades.

As drafted, the auditing standards may not fully achieve the objective of improving the foundation for future standard-setting. Additionally, more clearly articulating the basic processes could encourage more high quality audits. Specifically:

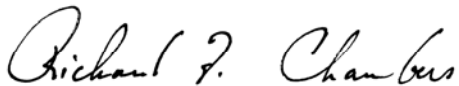
1. Auditing Standard Number 5 provided appropriate guidance that audit procedures should be focused on areas where there is at least a reasonable risk of a material misstatement of the consolidated financial statements. We believe the same guidance should be clear and prominent in standards related to financial statement audits.
2. Risk assessment is the initial step in effective audit planning. Rather than the "finalized" plan directing the risk assessment, the risk assessment should be performed at the beginning of audit planning to shape the final audit plan.

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3. We recommend standards on audit supervision be broken out from the standard on planning as they are two distinct topics. The discussion on supervision could better delineate the roles and responsibilities of the engagement partner versus other members of the audit team.
4. The discussion concerning the need for specialized skills or knowledge only discusses information technology skills; other specialized areas should be explicitly mentioned.
5. Consideration of the control environment is limited to it being a component of the system of Internal Control over Financial Reporting (ICFR). While the control environment is critical to ICFR, it is also critical to understanding the inherent risks of the company being audited. The control environment should be considered for all audits, not only for ICFR audit work.
6. There is a distinction between automated and manual processes. In practice business processes are often a combination of manual and automated activities. In addition, the discussion of automated activities implies the most formal type of automation and does not address the more common use of user-managed applications, including spreadsheets and databases.

The IIA welcomes the opportunity to discuss any and all of these recommendations with you. We offer our assistance to the PCAOB in the continued development of this guidance.

Best Regards,



Richard Chambers, CIA

**About The Institute of Internal Auditors**

The IIA is the global voice, acknowledged leader, principal educator, and recognized authority of the internal audit profession and maintains the *International Standards for the Professional Practice of Internal Auditing (Standards)*. These principles-based standards are recognized globally and are available in 29 languages. The IIA represents more than 150,000 members across the globe, and has 99 affiliates in 165 countries that serve members at the local level.

Attachment A  
Institute of Internal Auditors (IIA)  
Response to PCAOB - Proposed Auditing Standards Related to the Auditor's Assessment of and  
Response to Risk

Questions from Appendix 9 of the proposed standards are in bold italics, with the IIA responses following.

Proposed Standard - Audit Risk in an Audit of Financial Statements

***1. Does the proposed standard appropriately describe audit risk and its component risks?***

A material misstatement is assessed for the consolidated financial statements taken as a whole. The proposed standard breaks the risk of material misstatement into two levels – the overall financial statement level and the assertion level. The discussion in paragraphs 6 and 7 seems to lose the focus on the financial statements as a whole and introduces consideration of the affect on individual assertions. While consideration of the impact on individual assertions is proper, tying this consideration back to the ultimate objective – the financial statements taken as a whole – is not sufficient. We recommend the wording more explicitly and directly state that consideration of this risk at the assertion level is only an intermediary step for assessing the impact on the financial statements as a whole.

Paragraph 9 addresses detection risk. The last sentence in the paragraph does not fully differentiate between the design and operating effectiveness of audit procedures. An improvement may read: “Detection risk is a function of the effectiveness of the design of an audit procedure and the operating effectiveness of the execution of the procedure by the auditor”.

Paragraph 10 states: “The level of detection risk is reduced through the performance of substantive procedures.” Detection risk can also be reduced through compliance testing of internal controls. The greater the confidence the auditor has in the adequacy of the system of internal control over financial reporting, the lower the auditor’s detection risk.

Proposed Standard - Audit Planning and Supervision

***2. Is it reasonable and appropriate to extend the Auditing Standard No. 5 requirement regarding consideration of matters important to the audit of internal control over financial reporting to audits of financial statements?***

The factors considered in Auditing Standard No. 5 are critical in gaining a proper understanding of an entity subject to audit, either an audit of internal control over financial reporting or financial statements. The extension of the AS No. 5 requirements is appropriate.

***3. Is the direction regarding multi-location engagements reasonable and appropriate?***

Audit procedures should be limited and focused on the risk of material misstatement to the consolidated financial statements. The allocation of materiality, as suggested in the guidance, could result in procedures that are not necessary.

When assessing the risk of material misstatement to the consolidated financial statements that may exist at one or more individual locations, we recommend consideration be given to the following:

- Is there a reasonable risk of misstatement at an individual location that would be material to the consolidated financial statements?
- Is there a common cause of misstatement at one or more individual locations (e.g., the use of the same automated systems, or the exercise of controls by the same individuals) such that there is an aggregated reasonable risk of misstatement across multiple locations that would be material to the consolidated financial statements?

Please also refer to our answer for question 4.

**4. *Is more direction needed regarding multi-location engagements? If so, in what areas is additional direction needed?***

As the incidence of regional and global shared service centers increases, audits need to be able to manage risks and activities that are not aligned along entity or location but along process lines. Guidance is needed to audit companies which are organized in this manner.

**5. *Are the responsibilities of the engagement partner for planning and supervision appropriate and reasonable, and is the proposed direction clear?***

As mentioned below, the topic of may be better addressed as a separate standard with the responsibilities of each role in an audit provided appropriate attention. As currently written, the responsibility of the engagement partner versus other audit team members is not clear.

**Other matters**

Paragraph 4 indicates an audit plan should include planned risk assessment procedures. Paragraph 10a confirms the plan is to direct the risk assessment procedures. Following this procedure may result in failure to fully understand risk prior to completing an audit plan and can result in an improperly focused audit. Risk assessment procedures need to be performed prior to finalization of an audit plan. An audit plan must consider a full assessment of risk before being finalized.

The list of planning activities in paragraph 7, while not intending to be comprehensive, could be enhanced as follows:

- It is missing any mention of a category of critical factors for audit planning. There is no mention of entity-level factors of the entity such as the attitude of management towards financial reporting, the level of resources devoted to financial reporting, the competency and training of accounting personnel, etc.
- Limiting the concern over legal and regulatory matters to those of which the company is aware implies such matters of which the company is not aware cannot impact the company's financial reporting.
- The complexity of the company's accounting is as important as the complexity of the company's operations.

The statement: "determine the significant factors that affect the direction of the engagement team" in Paragraph 9b may be of more value if it included more specific information.

The title preceding paragraph 13 and the text of paragraph 13 appear to be intended to address situations where specialized skill or knowledge is needed to successfully complete an audit. However, paragraphs 14 and 15 only address IT skills. This could imply that only IT skills are specialized enough to require additional assistance. The increasing complexity of accounting related to derivatives, uncertain tax positions, business combinations, etc. can create situations where specialized skill or knowledge is needed for these issues. For many companies, IT issues represent much less audit risk than these complex accounting areas. The brief general mention of generic specialized skills in paragraph 13 could be more extensive.

Paragraph 17 briefly mentions that planning activities may need to be expanded for initial audits. The level of risk an initial audit brings can be much higher than this brief mention implies. The discussion should be expanded appropriate for the level of risk.

This standard covers both planning and supervision. These are both critical, but separate topics in an audit. Planning is a distinct phase in an audit, but supervision takes place throughout all phases of an audit. For example, supervision occurs during planning, and execution, and reporting. We recommend supervision be addressed in a separate standard.

#### Proposed Standard - Identifying and Assessing Risks of Material Misstatement

**6. *Does the proposed standard clearly and adequately describe the auditor's responsibilities for performing risk assessment procedures?***

As discussed earlier, the tasks of audit planning versus risk assessment are out of order, and could cause confusion. In addition, the guidance for assessing whether there is a reasonable level risk of material misstatement of the consolidated financial statements at one or more individual locations not sufficient.

**7. *Are the additional procedures in paragraph 13 that the auditor should consider performing when obtaining an understanding of the company and its environment reasonable and appropriate for audits of issuers? Should these procedures be specifically required for all audits, or is the responsibility to consider performing the procedures sufficient?***

The requirement is reasonable and appropriate, but the handling of this requirement in the standard is not sufficient. This topic is addressed in paragraphs 25 through 27 which is a part of the section "Obtaining an Understanding of Internal Control Over Financial Reporting (ICFR)". While the control environment is critical in assessing ICFR, it is not limited to being a topic only applicable to ICFR. Control environment is a critical component of inherent risk in addition to control risk. The choice of placement of this topic minimizes its comprehensive impact on a company and the effects it has.

Addressing the control environment should be required due to its pervasive impact on the risk of an audit. Specifically how this consideration is structured in an audit should be dependent on the specific audit situation.

**8. *Is the new requirement to assess certain matters related to the control environment component of internal control over financial reporting reasonable and appropriate? Is the difference between the required performance for an audit of internal control over financial reporting and an audit of financial statements only clear?***

See response to question 7.

**9. *Is the additional direction regarding the period-end reporting process reasonable and appropriate for audits of financial statements only?***

The consideration of period-end reporting process is in the section titled “Information System Relevant to Financial Reporting and Communication”. See the discussion following question 11 for comments on this section.

**10. *Are the requirements and direction regarding the auditor’s responsibilities for evaluating design and implementation of controls as part of obtaining an understanding of internal control over financial reporting sufficient and clear? If not, what additional direction is needed?***

Yes

**11. *Does the additional description of the key engagement team members provide a better understanding of the expected participants in the discussion?***

Yes

**12. *Does the discussion of significant risks in this standard provide sufficient direction to enable auditors to identify significant risks?***

Yes

**13. *Should the proposed standards include specific requirements and direction regarding documentation, e.g., summaries of the identified and assessed risks and the linkage to the auditor’s responses?***

Auditing Standard No. 3 provides sufficient guidance for the auditor to use judgment in preparing documentation.

**Other Matters**

Paragraph 11 mentions selected external factors that should be considered during the risk assessment in an audit. A key external factor not included on this list is an understanding of the regional business practices in which the company does business. With the increased globalization of business activity, and the diversity of business practices (as evidenced in the significant increase in FCPA violations, as an example), this factor is as important as the other factors listed.

Paragraph 12 lists aspects of the nature of the company that should be considered. A key element of the nature of the company is information about how the company performs its key business processes (e.g., invoicing, manufacturing, pension management). Of interest are who performs the process, where it is done, and what basic process is followed.

The Period-end Financial Reporting Process section in paragraph 32 is under the broader heading of “Information System Relevant to Financial Reporting and Communication”. The placement of this paragraph could be confusing as it discusses a number of procedures which would not normally be considered part of an information system.

Paragraph 48 requires the audit team to set aside any prior beliefs they have about the integrity of management when considering the risk of fraud. This is appropriate if those beliefs are based on the absence of prior issues with management integrity. However, if the audit team has knowledge of factual information which shows a lack of integrity or honesty by management, this should not be set aside during the discussions described in this paragraph.

Paragraph 52c outlines inquiries to be made of the internal audit function regarding fraud risk. In the following section d, point (4) directs an inquiry concerning whether an employee is aware of instances of management override of controls and the nature and circumstances of such overrides. This inquiry should be included in section c as an inquiry also of internal auditors.

Appendix A (page A3-25) discusses manual versus automated systems. This discussion has not been updated to address current IT environments. The discussion makes a stark contrast between manual and automated systems, while in practice this distinction is often more blurred. The increased use of user-managed applications based on spreadsheet and database software increases the presence of business processes which are a blend of manual and automated systems. As written, the discussion assumes all IT systems are in formalized mainframe type environments. The most significant risks can often come from the far less formal, but still IT dependent, user-managed applications built on simpler computer applications. Please refer to the *Guide to the Assessment of IT and Business Risk*, published by the Institute of Internal Auditors, for a more complete description of the range of IT risks to be considered and the integration of IT and manual processes.

#### Proposed Standard – The Auditor’s Responses to the Risk of Material Misstatement

**14. Does the proposed standard clearly describe the auditor’s responsibilities regarding tests of controls in integrated audits and in audits of financial statements only?**

Yes

**15. Are the requirement and direction regarding tests of controls appropriately aligned with Auditing Standard No. 5?**

Yes

**16. Does the proposed standard clearly describe the auditor’s responsibilities regarding substantive procedures?**

Yes

#### Proposed Standard - Evaluating Audit Results

**17. Does the proposed standard clearly describe the auditor’s responsibilities regarding the evaluation of audit results?**

Yes

**18. Are the requirements and direction regarding the accumulating identified misstatements and evaluating uncorrected misstatements appropriate and adequate?**