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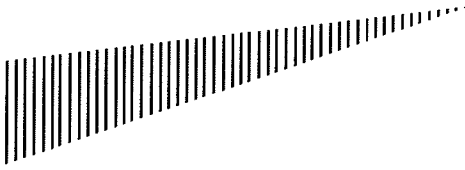
Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk, and Conforming Amendments to PCAOB Standards, PCAOB Rulemaking Docket Matter No. 026

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 proposed auditing standards related to the auditor's assessment of and response to risk (the proposed standards).

We support the issuance of the proposed standards and the PCAOB's objective to update its existing interim standards to reflect improvements that firms have made in risk-based audit methodologies. We also concur with the Board's recognition that risk assessment, appropriately applied, should underlie the entire audit process and result in audit procedures tailored to the company's size and complexity. We strongly support the Board's effort to eliminate unnecessary differences between its risk assessment standards and other risk assessment standards, particularly those of the International Auditing and Assurance Standards Board (IAASB) and the AICPA Auditing Standards Board (ASB). As discussed further in our comments below, we strongly support convergence of auditing standards and we urge the PCAOB to continue to further consider and integrate its standard-setting process with those of the other standards-setters. We believe that considering the work of other standards-setters will result in a more effective and efficient standard-setting process and increased understanding of the auditing standards, which should facilitate implementation by auditors.

We are aware of the challenge of developing risk assessment standards that provide sufficient direction to the auditor to identify, assess and respond to risk appropriately, yet allow and encourage the appropriate use of professional judgment. We believe it is very important that auditors use sound professional judgment to identify and address those risks that, if not addressed, could result in an unacceptable risk that the auditor will not obtain reasonable assurance that the financial statements are free of material misstatement. We also believe it is very important to recognize that the judgments made regarding the identification and assessment of risks, determining the nature, timing and extent of audit procedures, and what constitutes sufficient appropriate audit evidence, are necessarily dependent on the facts and circumstances known to the auditor during the conduct of the engagement.



We offer a number of overall comments below related to the proposed standards, including their relationship to other PCAOB standards and the drafting conventions used in their development. We also provide more detailed comments on each individual proposed standard in an attachment to this letter.

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

Sincerely,

Ernst + Young LLP

Overall Comments Related to the Proposed Standards

Relationship of Proposed Standards to Auditing Standard No. 5 (AS 5)

Paragraph 7 of the proposed standard, *Identifying and Assessing the Risks of Material Misstatement*, states that "the risks of material misstatement of the financial statements are the same for both the audit of internal control over financial reporting and the audit of the financial statements. Accordingly, the auditor's risk assessment procedures should apply to both the audit of internal control over financial reporting and the audit of the financial statements." We agree. However, we believe that the current structure of the proposed standards may lead some to question whether the risk assessment process is different for an audit of the financial statements only (for example, an audit of the financial statements of a non-accelerated filer) versus an audit of the financial statements as part of an integrated audit (one that includes an audit of the issuer's internal control over financial reporting).

Under a risk-based approach, an auditor is required to obtain an understanding of the entity and its environment, including its internal control, and to assess the risks of material misstatement. These fundamental requirements are applicable whether the auditor is performing an integrated audit or an audit of the financial statements only. However, the proposed standard, *Audit Risk in an Audit of Financial Statements*, seems to suggest that there are separate and distinct considerations of audit risk for the financial statement component of an integrated audit versus an audit of the financial statements only. For example, paragraph 1 states that the proposed standard establishes requirements and provides direction regarding the auditor's consideration of audit risk in an audit of the financial statements. The note to paragraph 1 states that AS 5 establishes requirements and provides direction regarding the auditor's consideration of risk in an audit of internal control over financial reporting.

In addition, we find the Board's approach of combining the proposed standards with AS 5 to be inconsistent. For example:

- ▶ Guidance from AS 5 is incorporated in some places in the proposed standards (for example, the bullet points in paragraph 7 of the proposed standard, *Audit Planning and Supervision*, are nearly identical to those in paragraph 9 of AS 5 while paragraphs 14 - 16 of the proposed standard, *The Auditor's Responses to the Risks of Material Misstatement*, repeat existing paragraphs in AS 5).
- ▶ In other places, only reference to AS 5 is made rather than repeating its language (for example, footnote 16 to paragraph 22 of the proposed standard, *The Auditor's Responses to the Risks of Material Misstatement*, footnote 5 to paragraph 6 and footnote 25 to paragraph 65 of the proposed standard, *Identifying and Assessing Risks of Material Misstatement*). These references would suggest that an auditor performing an audit of the financial statements only would be required to comply with the referenced paragraphs of AS 5. We do not believe that was the Board's intent.

We also note that AS 5 contains additional guidance related to risk assessment procedures that is not included in the proposed standards. For example, Paragraph 21 of AS 5 requires the auditor to use a top-down approach to the audit of internal control over financial reporting, but this approach is not discussed in the proposed standards. We believe that a top-down, risk-based approach is fundamental

to the planning and scoping of any financial statement audit and contributes to both audit effectiveness and efficiency.

As a further example of guidance in AS 5 that is not included in the proposed standards, paragraphs 34 through 38 of AS 5 provide for certain basic risk assessment activities to be undertaken to identify risks at the assertion level. AS 5 then goes on to state that frequently the most effective way to carry out these risk assessment activities is to perform a walkthrough. The proposed standards do not contemplate the risk assessment activities noted in paragraphs 34 through 38 of AS 5, nor do they acknowledge the effectiveness of performing walkthroughs to identify risks of material misstatement.

Because the risk assessment process should be the same for an audit of the financial statements only as well as the financial statement component of an integrated audit, we recommend the Board incorporate into the proposed standards (or other interim PCAOB standards as appropriate) all guidance relating to identifying, assessing and responding to risks in an audit of the financial statements (whether for an audit of the financial statements only or as part of an integrated audit) with appropriate conforming changes to AS 5. As a result, AS 5 would only include the additional guidance for performing an audit of internal control over financial reporting as part of an integrated audit. We believe this would make clear to auditors that the fundamental concepts of a risk-based approach apply to any audit conducted in accordance with PCAOB standards.

Integration of Fraud Guidance

We acknowledge the benefits of better integration of fraud considerations into the risk assessment process. We also believe that the consideration of fraud risks and awareness to the possibility of fraud should be continuous throughout the audit and not a "bolt on" to other audit procedures. However, we believe that there is a 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 the risks of material misstatement due to fraud. 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 are concerned that, after reflecting on the proposed 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 standards. We are not convinced that auditor performance will be influenced to any significant degree 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. We note that the Board has taken this approach in paragraph 13 of the proposed

standard, *The Auditor's Responses to the Risk of Material Misstatement*. This paragraph summarizes the requirements in AU 316.58 - 67 related to the auditor's required procedures to specifically address the risk of management override of controls and appropriately incorporates these requirements into the auditor's process of responding to risks of material misstatement, while still maintaining the requirements and guidance in AU 316.

We offer additional detailed comments related to the fraud content in the proposed standards for the Board's consideration in the attachment to this letter.

Use of Presumptively Mandatory Requirements

In certain instances, the Board's intent regarding the auditor's responsibilities embodied in the proposed standards is unclear. For example, the use of the terms "should evaluate," "should consider," "should include," "should take into account" and "should assess" throughout the proposed standards may lead to confusion as to the specific activities to be performed by the auditor. The Board's Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards* (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, consideration of the action or procedure is presumptively mandatory, while the action or procedure is not. Rule 3101 does not discuss or provide direction relative to the various other uses of the word "should" throughout the proposed standards. We believe that the Board's variation in the use to the term "should," without discussion of the intent of such uses, causes confusion regarding what is expected in terms of auditor performance. In addition, by using a formulation different from that used in extant PCAOB standards, there may be an implication that the PCAOB expects a different auditor action.

We suggest that the Board use the same terminology as is used in extant standards, if the auditor responsibility is intended to be the same. If the responsibility is not intended to be the same, we recommend the Board clarify its expectation of auditors both in terms of the specific thought process or action required, and the documentation thereof.

Distinction between Mandatory and Presumptively Mandatory Requirements

We support the Board's infrequent use of "must" in the proposed standards. However, we recommend that the Board review its standards for consistency in the use of "must" and "should." For example, AS 5, paragraph 9 states that "the auditor *should* properly plan the audit of internal control over financial reporting and properly supervise any assistants," but paragraph 3 of the proposed standard, *Audit Planning and Supervision*, states that "the auditor *must* adequately plan the audit and properly supervise the members of the engagement team."

In contrast to the PCAOB drafting convention, we note that the IAASB only uses one term throughout the clarified ISAs in describing auditor requirements. In light of the infrequent use of the word "must" throughout the PCAOB standards as well as the variation in the use of the word "should" as noted above, we ask the Board to consider whether this is an appropriate time to challenge Rule 3101 and consider an overall "clarity project" to further refine the drafting conventions that will be used throughout all of the PCAOB standards. This would provide the Board the opportunity to challenge

whether the use of both "must" and "should" is still necessary to distinguish between mandatory and presumptively mandatory requirements.

Prescriptive Requirements

The Board states in its Release to the proposed standards (page 6): "The proposed standards also reflect the Board's recognition of the importance to the audit process of sound professional judgment. As under the PCAOB's existing auditing standards, auditors would have to exercise professional judgment to determine how best to fulfill the requirements of the proposed standards under particular circumstances. "

We agree with the statement above and also believe that auditing standards should be more "principles-based" than "rules-based" in order to provide the auditor with the opportunity to apply professional judgment in performing the audit. However, we believe that in several instances the proposed standards include unnecessarily prescriptive requirements that limit the auditor's ability to use judgment in the circumstances or to scale the audit. We have noted some of these instances in the attachment to this letter.

We also ask the Board to carefully consider each use of the word "should" to make sure that the specific performance requirement is clear to the auditor and provide additional guidance as necessary to support or enhance the auditor's understanding of the requirement.

The Relationship of the PCAOB Standards to Other Auditing Standards

We fully support the Board's consideration of the work of other standards-setters, as evidenced by the efforts to consider overall alignment of the proposal's organizational structure and guidance with the corresponding risk assessment standards of the IAASB. We acknowledge the steps taken, and urge the PCAOB to continue to implement the objective in the Board's strategic plan for 2008-2013 to "participate in the work of, and engage with, other standards-setting bodies to benefit from, and as appropriate incorporate, new developments and techniques to promote high quality audits worldwide." We believe that increased and ongoing involvement by the PCAOB with other standard-setting bodies will 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 performed for legal or regulatory reasons. These benefits will enhance auditors' understanding, implementation, and consistent execution of standards on all the audits they perform, not just those subject to the Board's oversight.

We acknowledge and strongly support the comparison in Appendix 10 of significant differences in requirements between the Board's proposed standards and those of the corresponding ISAs of the IAASB. The recent exposure by the ASB of its clarified risk assessment standards similarly includes an analysis of differences between its proposed standards, the PCAOB's proposed standards, and the ISAs. Such comparisons represent a positive step in promoting greater convergence of auditing standards and in articulating the reasons for differences. Some of our comments in the attachment to this letter identify areas in which we believe greater convergence could be achieved without jeopardizing the Board's objective to issue robust standards directed to audits, including integrated audits, of SEC

issuers. Further, we suggest that the Board consider providing more detailed rationale for differences between the proposed standards and the standards of both the IAASB and the ASB to assist auditors that serve both issuer and nonissuer clients in understanding and implementing the standards.

Drafting Conventions used by the PCAOB

As stated above, we support the PCAOB's objective to take into account the IAASB risk assessment standards in developing the proposed standards; however, we have concerns that adopting some of the drafting conventions used by the IAASB (for example, the use of objectives in each proposed standard), but not all of the clarity drafting conventions adopted by the IAASB, may cause some confusion or the perception of unintended differences between the two sets of standards. In addition, the adoption of these proposed standards will introduce a third "style" of standard that is inconsistent with the Board's other standards, as well as numerous conforming amendments, without a clear vision for integrating the standards in the future.

The IAASB and ASB both have undertaken projects to redraft all of their auditing standards in a consistent manner with the intent of promoting greater understanding and more consistent application of their standards by auditors, which in turn furthers the objective of audit quality. The IAASB's clarity project is nearing completion; the ASB's is in progress.

We encourage the Board to undertake a similar project to introduce greater consistency and clarity in its standards. Accordingly, we support the Board's intent to develop a concept release to obtain public comment and feedback regarding the Board's review of the interim standards, and suggest that the Board consider feedback on that concept release in connection with making revisions to the proposed standards prior to adoption.

Given the IAASB drafting conventions and our comments above, we offer the following comments for the PCAOB's consideration related to the drafting conventions of the proposed standards and future proposed standards.

Objectives

We support the use of objectives in the proposed standards but believe that it is necessary for the PCAOB to consider from the outset how objectives are intended to fit into the overall framework of PCAOB standards going forward. In the ISAs, for example, objectives of individual standards are intended to assist the auditor in planning and performing the audit to achieve the overall objectives of the auditor set forth in ISA 200 (Revised and Redrafted), *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*. As stated in paragraph 20 of ISA 200, the auditor should use the objectives in relevant ISAs to (a) determine whether any audit procedures in addition to those required by the ISAs are necessary in pursuance of the objectives stated in the ISAs, and (b) evaluate whether sufficient appropriate audit evidence has been obtained. We believe that the Board should add objectives to each of its standards, not just the seven in the proposal, and similarly link them to an overarching standard that provides context for their use.

In addition, we believe that objectives should articulate a statement of purpose. We do not believe it is appropriate or necessary for objectives in individual standards to contain the "must" or "should"

terminology governed by the Board's Rule 3101. Such words should be reserved for the requirements that support the objectives of the standards. Finally, we believe that some objectives in the proposed standards are overly broad (for example, the objectives in paragraph 2 of the proposed standard, *Evaluating Audit Results*, and paragraph 3 of the proposed standard *Audit Evidence*). Our recommendations for revising such objectives are included in the attachment to this letter.

Additional Guidance

Although we generally support the brevity of the proposed standards, there are some areas in which we believe the standards could be improved with additional explanatory guidance, some of which is included in extant PCAOB, IAASB or ASB standards. Examples of such areas are included in the attachment to this letter.

Scalability

We support the addition of guidance, where applicable, to assist auditors in achieving the objectives of the proposed standards for smaller, less complex companies. We believe that the IAASB's convention for including considerations for smaller, less complex entities throughout the ISAs is appropriate and ask the Board to consider that convention in drafting its standards.

Multi-location Audits

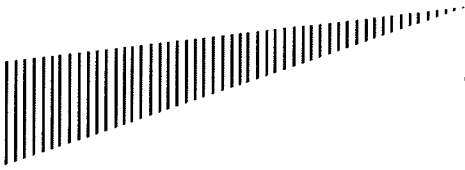
We note that the proposed standards, *Audit Planning and Supervision*, and *Identifying and Assessing Risks of Material Misstatement*, address some circumstances specific to multi-location audits. We believe that more comprehensive guidance related to performing an audit of the financial statements for a multi-location entity, particularly related to assessing risks and scoping the engagement, would be helpful. Therefore, we suggest that the PCAOB provide expanded guidance related to this topic throughout the proposed standards.

For example:

- ▶ Paragraph 11 of proposed standard, *Audit Planning and Supervision*, provides matters to consider regarding the selection of a particular location or business unit in a multi-location audit; however, no direction is provided for the auditor in determining the extent to which auditing procedures should be performed at selected locations once those matters have been considered.
- ▶ The note to paragraph 41 of proposed standard, *Identifying and Assessing Risks of Material Misstatement*, discusses how an auditor might assess information obtained in other engagements in a multi-location audit, but does not provide any guidance for obtaining an understanding of internal control at different locations, which is equally as challenging.

Effective Date

We note that the Board did not propose an effective date in the proposed standards. We understand that the effective date is dependent upon the timing of adoption of final standards, but encourage the



Board to provide sufficient time for firms to incorporate the standards into their respective audit methodologies and training programs prior to implementation.

Other Comments Related to the Proposed Standards

We present below our more detailed comments specific to each of the seven proposed standards and the conforming amendments to the PCAOB standards. To facilitate your review, 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

- ▶ Paragraph 5 defines the risk of material misstatement as “the risk that the financial statements are materially misstated due to error or fraud.” This definition contrasts with 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.” We believe that including the words “prior to the audit” makes it clear that the risk of material misstatement is the entity’s risk. We therefore recommend adding these words to the first sentence in paragraph 5.
- ▶ We do not believe that paragraph 6 sufficiently describes the types of risks of material misstatement at the financial statement level or how to identify such risks. In addition, the proposed standard does not describe how risks of material misstatement at the financial statement level are assessed. Therefore, we recommend that the PCAOB include additional guidance similar to that in ISA 315 (Redrafted), *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment* (ISA 315), paragraphs A98-A101 related to the identification and assessment of risks of material misstatement at the financial statement level.

Appendix 2: Audit Planning and Supervision

- ▶ We believe that paragraph 2 is sufficient to describe the objective of the proposed standard. Therefore, we recommend that paragraph 3 be deleted from the proposed standard. [*Objectives*]
- ▶ Paragraph 7 states that “the auditor should evaluate whether the following matters are important to the company’s financial statements and internal control over financial reporting and, if so, how they will affect the auditor’s procedures.” We believe that these are matters the auditor typically considers in planning an audit engagement but generally would not entail a detailed evaluation. We therefore recommend that the PCAOB use the phrase “should consider” rather than “should evaluate” in paragraph 7. [*Use of presumptively mandatory requirements*]
- ▶ We believe that certain matters discussed in paragraph 7 are more appropriately included as part of the discussion of the overall audit strategy assessment in paragraph 9. These matters, which relate more to auditor judgment and audit planning are as follows:
 - ▶ Knowledge of the company’s internal control over financial reporting or other information relevant to identifying risks of material misstatement obtained during other engagements performed by the auditor;
 - ▶ The auditor’s preliminary judgments about materiality, risk, and other factors relating to the determination of material misstatements and material weaknesses;
 - ▶ Preliminary judgments about the effectiveness of internal control over financial reporting.

- ▶ Included in the list of matters in paragraph 7 is "preliminary judgments about the effectiveness of internal control over financial reporting." We recommend that the Board revise this bullet point so that it is clear that it pertains to the *auditor's* preliminary judgments, which would be consistent with the bullet point related to materiality in paragraph 7.
- ▶ Paragraph 9b states that the auditor should determine the significant factors that affect the direction of the engagement team. It is not clear what is meant by "direction" of the engagement team. ISA 300 (Redrafted), *Planning an Audit of Financial Statements* (ISA 300), paragraph 7(c) requires the auditor to "consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts." We recommend that the Board consider the ISA 300 language to improve the clarity of the requirement in paragraph 9b.
- ▶ Paragraph 10 states that the auditor should develop a *written* audit plan (emphasis added). We suggest that the term "written" either be clarified to indicate that it can include both hardcopy and electronic documentation or that the reference to "written" be removed from the proposed standard.
- ▶ We recommend the following revision to paragraph 10b:

"The planned nature, timing and extent of tests of controls and substantive procedures at the assertion level.

We believe this revision to the requirement is consistent with the proposed standard, *Auditor's Responses to Risks of Material Misstatement*, and also with ISA 300 paragraph 8.
- ▶ We recommend the following revision to paragraph 12 to make the definition of "fraud risk" consistent with the other proposed standards:

"e.g., based on a revised assessment of the risks of material misstatement or discovery of a previously unidentified risk of material misstatement due to fraud ("fraud risk")."
- ▶ Paragraph 13 requires the auditor to "determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, apply the planned audit procedures, or evaluate audit results." Paragraphs 14 and 15 discuss specific requirements regarding the evaluation of whether an information technology ("IT") specialist is needed and the auditor's interaction with an IT specialist. The Board notes in Appendix 9 the prevalent use of specialists by auditors, such as forensic specialists, valuation specialists and actuarial specialists in addition to IT specialists. Therefore, we believe it would be helpful to indicate in paragraph 13 the different types of specialists that the auditor may use in connection with the audit. In addition, we believe that paragraph 15, including the footnote to that paragraph, should make clear that the requirement applies to any specialist that the auditor has decided to use. We believe it is particularly important to indicate that any specialist that functions as a member of the audit engagement team requires the same supervision as any other member of the engagement team. In addition, the auditor should have sufficient knowledge of the subject matter to be addressed by the specialist to enable the auditor to fulfill the requirements of paragraph 15.

Appendix 3: Identifying and Assessing Risks of Material Misstatement

- ▶ Paragraph 4b defines significant risk as "a risk of material misstatement that is important enough to require special audit consideration." Paragraph 4e of ISA 315 defines significant risk as "an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration." We believe the process of identifying significant risks is highly dependent on auditor judgment and experience and, therefore, recommend that the Board include the reference to the auditor's judgment in this definition. [*The relationship of the PCAOB standards to other auditing standards*]
- ▶ The reference in footnote 3 refers to a definition of *fraud* in AU 316. If the Board integrates relevant aspects of AU 316 into the proposed standards, we suggest that the Board 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: [*Integration of fraud guidance*]
 - For purposes of PCAOB auditing standards ~~the section~~, *fraud* is an intentional act that results in a material misstatement in financial statements that are the subject of an audit.
- ▶ We suggest the following revision to paragraph 13 to be consistent with the overall requirement to obtain an understanding of the company and its environment ("understanding of the company") in paragraph 8:
 - Reading public information about the company relevant to the ~~evaluation of the likelihood of material financial statement misstatements~~ identification of risks of material misstatement and the effectiveness of the company's internal control over financial reporting;
- ▶ Paragraph 14 contains footnotes that define the terms "objectives," "strategies" and "business risks." We suggest including these terms and the related definitions in a "Definitions" section of the proposed standard versus including them in footnotes. [*Drafting conventions used by the PCAOB*]
- ▶ We do not believe the proposed standard is clear with respect to the auditor's responsibility to identify and assess risks relative to company performance measures. Paragraph 16 states that the purpose is to identify those performance measures that affect the risks of material misstatement. However, it is not clear from paragraph 17 how the auditor might consider such measures in the context of identifying and assessing the risks of material misstatement, or the extent to which the presence of such performance measures might result in a higher or lower level of assessed risk. We recommend that the Board clarify the auditor's responsibilities with respect to company performance measures, and include specific examples to help auditors better understand both the types of measures to be considered and how those measures affect the risks of material misstatement.
- ▶ The fourth bullet point in paragraph 19 requires the auditor to obtain an understanding of the degree of transparency of the application of significant accounting principles and related financial reporting processes. We believe that further clarification or guidance relative to the auditor's

responsibility in this regard would be helpful, particularly regarding the meaning of "degree of transparency." [Additional guidance]

- ▶ Paragraph 22 states: "In obtaining an understanding of internal control, the auditor should evaluate the design of controls and determine whether the controls have been implemented." Paragraph 13 of ISA 315 provides that "when obtaining an understanding of controls *that are relevant to the audit*, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel" (emphasis added). We ask the PCAOB to clarify that the auditor does not need to evaluate the design and implementation of all controls, but rather only those controls that are relevant to the audit. Further, we suggest that the Board consider including a discussion of how walkthroughs may be used to accomplish the requirement (similar to paragraph 37 of AS 5). [The relationship of the PCAOB standards to other auditing standards]
- ▶ We suggest that the note to paragraph 32 be revised as follows:

Note: In an integrated audit, the auditor's procedures for obtaining an understanding of the company's ~~monitoring activities~~ period-end financial reporting process might be performed in conjunction with the evaluation of entity-level controls, as discussed in paragraphs 26-27 of Auditing Standard No. 5.
- ▶ The note to paragraph 34 states: "For purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than that which is normally obtained in an audit of financial statements only." We do not believe this statement is correct. As previously stated in this letter, we believe the risk assessment process is the same for audits of internal control over financial reporting and financial statement only audits and, therefore, the auditor's process for *understanding* control activities to assess the factors that affect the risks of material misstatement and to design further audit procedures should be the same. We acknowledge that the further audit procedures may be different, but do not believe the auditor would gain an understanding of control activities for a broader range of accounts and disclosures. [Relationship of proposed standard to AS 5]
- ▶ We suggest changing the last bullet point to paragraph 48 as follows:

~~Communication~~ Discussion about the potential audit responses to the susceptibility of the company's financial statements to material misstatement due to fraud.
- ▶ Paragraph 52d requires the auditor to make fraud-related inquiries of accounting and financial reporting personnel, including, in particular, employees involved in initiating, authorizing, processing, or recording complex or unusual transactions ... " In addition, paragraph 53 requires the auditor to "inquire of others within the company about whether they have knowledge of fraud, alleged fraud, or suspected fraud."

Paragraph 54 provides guidance to the auditor in determining which individuals within the company to whom the inquiries required by paragraphs 52d and 53 should be directed. It directs the auditor to "... assess who might reasonably be expected to have information that might be

important to the identification and assessment of fraud risks ...” Although the concepts and the words are similar to the extant requirement in paragraph 24 of AU 316, we believe that this changes the nature of the requirement and, in doing so, makes the requirement more confusing and potentially difficult to implement in practice.

Paragraph 24 of AU 316 requires the auditor to make inquiries of others within the entity. It allows the auditor to use professional judgment in determining those to whom such inquiries should be directed, and paragraph 25 provides examples of others to whom the auditor may wish to direct these inquiries. Paragraph 24 also directs the auditor to consider whether there may be certain individuals that might provide information relevant to the identification of fraud risks or that would further corroborate information about fraud risks obtained from other sources. Unlike paragraph 54 of the proposed standard, it does not direct the auditor’s inquiries only to these individuals.

We have always understood the requirement in paragraph 24 of AU 316 to suggest that the auditor should make a number of inquiries of accounting, financial and other personnel throughout the entity in the course of performing the audit. For example, in meeting with a member of the entity’s accounting department to obtain an understanding of the processing of transactions and related controls, the auditor might ask if the employee has seen anything unusual in the processing of routine transactions or handling of exceptions in transaction processing that might suggest the possibility of management override of controls. In our view, these inquiries should be part and parcel of the ongoing dialogue that occurs throughout the audit process, and not limited to individuals who the auditor believes might possess information important to the identification and assessment of fraud risks.

We recommend that the Board challenge the construct and wording in paragraphs 52d, 53 and 54 to clarify the auditor’s responsibilities regarding fraud-related inquiries of others in connection with the audit. In particular, we ask the Board to be cognizant of the potential difficulties for auditors to fulfill a requirement to make inquiries of accounting and financial reporting personnel in a large, multilocation entity without an explicit acknowledgment that the auditor can use professional judgment in determining those to whom the inquiries should be directed.

- ▶ Paragraph 56 states: “The auditor should identify and assess the risks of material misstatement at the financial statement level and the assertion level.” We believe the auditor’s identification and assessment of the risks of material misstatement are made in the context of the auditor’s determination of significant accounts and disclosures and their relevant assertions. That is, an auditor first determines whether an account or disclosure is significant and whether an assertion is a relevant assertion, and then assesses the risks of material misstatement related to those accounts and assertions. Therefore, we suggest that the Board consider moving the reference in paragraph 56e to the identification of significant accounts and disclosures and their relevant assertions to the introductory sentence of paragraph 56 to make it clear that the process of identifying, evaluating and assessing the risks of material misstatement described in 56a-d and f is accomplished after first identifying significant accounts and disclosures and their relevant assertions.
- ▶ We believe that paragraphs 64 and 65 of the proposed standard need to be clarified to clearly address that the auditor identifies or assesses fraud risks after taking into consideration an evaluation of the entity’s programs and controls that address the risks. We suggest that the proposed standard incorporate language similar to the following from extant AU 316 paragraph 45 to address this:

After the auditor has evaluated whether the entity's programs and controls that address identified risks of material misstatement due to fraud have been suitably designed and placed into operation, the auditor should assess these risks taking into account that evaluation. This assessment should be considered when developing the auditor's response to the identified risks of material misstatement due to fraud.

We believe it should be clear to the auditor that if a control is identified that mitigates a fraud risk, then the auditor's response should be to test that control, and no further response to the risk of fraud may be required. Adding this explicit language will make the proposed standard consistent with the requirements of extant AU 316 paragraph 45. [*Integration of fraud guidance*]

- ▶ We do not believe that Appendix A - Consideration of Manual and Automated Systems and Controls has been referenced within the body of the proposed standard. We suggest that the Board add such a reference (for example, to paragraph 29) to clarify the intended purpose of the Appendix.

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

- ▶ Paragraph 1 states: "This standard establishes requirements and provides direction regarding designing and implementing appropriate responses to the risks of material misstatement." However, we believe that the standard should have a stronger link between the identification and assessment of risks of material misstatement and the response to those risks. We understand that the Board considered this matter. It concluded that obtaining sufficient appropriate audit evidence to support the auditor's opinion requires the auditor to adequately respond to the risks of material misstatement. Although related to the appropriateness of the auditor's risk assessments, the response is separate from the assessment.

In each audit the auditor performs risk assessment procedures to determine where risks of material misstatement exist. Based on this assessment, the auditor designs and executes procedures to obtain sufficient appropriate audit evidence. The effectiveness with which the risk assessment is performed logically affects any audit response. The intrinsic relationship between risk assessment and the audit response is a fundamental aspect of the audit risk model. Therefore, we recommend that the standard include the concept that the auditor designs and implements appropriate responses to risks of material misstatement that he or she has identified and assessed as to the severity of risk. [*The relationship of the PCAOB standards to other auditing standards*]

- ▶ We suggest revising the objective in paragraph 3 as follows to be consistent with paragraph 3 of ISA 330 (Redrafted), *The Auditor's Responses to Assessed Risks* (ISA 330 and to better reflect an outcome-based approach that provides both specificity and a link to the requirements of the proposed standard [*Objectives*]):

The objective of the auditor is to obtain sufficient appropriate audit evidence about the assessed ~~address the~~ risks of material misstatement through designing and implementing appropriate ~~overall audit responses and audit procedures to~~ those risks.

- ▶ Paragraph 4e states that "The auditor should evaluate whether it is necessary to make general changes to the nature, timing or extent of audit procedures to adequately address the risks of material misstatement." We ask the Board to consider including additional guidance and examples to clarify the meaning of "general changes." *[Additional guidance]*
- ▶ Paragraph 5 includes a definition of "professional skepticism." We suggest the Board include this in a separate "Definitions" section within this proposed standard or reference AU 316.13. *[Drafting conventions used by the PCAOB]*
- ▶ We ask the Board to consider replacing the term "fraud risks" in Paragraphs 9, 11 and 12, and throughout the proposed standards with "identified fraud risks," which would be consistent with the use of this term in paragraph 10 of the proposed standard.
- ▶ Paragraph 10 refers to "his or her fraud risk assessment." We note that the conforming amendments to AU 316 have deleted the paragraphs related to the section "Assessing the Identified Risks After Taking Into Account an Evaluation of the Entity's Programs and Controls That Address the Risks" (AU 316.43 - 45). As such, we ask the Board to explain what is meant by "fraud risk assessment" in this proposed standard as the term is not introduced or used elsewhere. *[Integration of fraud guidance]*
- ▶ We note that the requirements to specifically address the risk of management override of controls in paragraph 13 of the proposed standard would still be included in the PCAOB's standards at AU 316.58 - 67 because no conforming amendments were made to delete these paragraphs from AU 316. We believe the approach taken in paragraph 13 illustrates how the Board could appropriately reference the relevant concepts from AU 316 into the proposed standards, while leaving AU 316 intact as a standard that addresses the auditor's complete understanding of fraud in an audit. We do, however, suggest the following revision to paragraph 13 to clarify that the proposed standard does not impose additional requirements on the auditor, but instead is repeating the requirements included in AU 316 *[Integration of fraud guidance]*:

The auditor *is required by AU section 316 to* should perform audit procedures to specifically address the risk of management override of controls including:
- ▶ Paragraph 17 refers to the auditor's control risk assessments. Paragraph 18 refers to the flexibility given to the auditor to assess the risk of material misstatement below the maximum level because of reliance on controls. We ask the Board to clarify whether "control risk assessments" and the "assessment of the risk of material misstatement" are intended to have the same meaning, and if so, use consistent terminology within the proposed standard.
- ▶ Footnote 14 to paragraph 18 suggests that, when testing controls in a financial statement audit, the period of reliance on controls may be less than the full year (i.e., the period covered by the company's financial statements). We believe that additional guidance about how this concept would be applied should be included in the proposed standard. The application guidance in ISA 330, paragraph A32, provides an example of how evidence pertaining only to a point in time may be sufficient for the auditor's purpose and explains that controls over the entity's physical

inventory counting at the period end may be an example of such a control. We recommend including examples such as this to clarify the meaning of this concept. *[Additional guidance]*

- ▶ Paragraph 19 requires the auditor to perform tests of controls "for each relevant assertion for which substantive procedures alone cannot provide sufficient appropriate audit evidence" but provides no guidance to explain when such circumstances may arise. We believe the Board should consider including guidance about circumstances where the use of IT is integral to the ongoing conduct of an entity's business and no documentation of transactions is produced or maintained, other than through the IT system, as described more fully in paragraphs A120-121 of ISA 315; (paragraphs 119-120 of AU section 318, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*; or in paragraphs 68-69 of the Board's interim standard AU 319, *Consideration of Internal Control in a Financial Statement Audit*. *[Additional guidance]*)
- ▶ The footnote to paragraph 22 states that paragraphs 37-38 of AS 5 provides direction on performing a walkthrough. We believe the guidance in paragraphs 37-38 of AS 5 should be more directly incorporated into the proposed standard because this guidance is relevant and valuable to any audit of financial statements. *[Relationship of the proposed standards to AS 5]*
- ▶ The Note to paragraph 25 states that to obtain evidence about the operating effectiveness of a control, the control must be tested directly, which is consistent with AS 5. We suggest including additional discussion to clarify the meaning of "tested directly." For example, we recommend 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. *[Additional guidance]*
- ▶ We ask the PCAOB to challenge whether the requirement in paragraph 38, as well as the heading preceding it ("Assessing Control Risk") are appropriately included in this proposed standard. The objective of this proposed standard is to address the risks of material misstatement through appropriate overall audit responses and audit procedures. We believe that including a requirement to assess control risk at the assertion level may be better incorporated into the proposed standard, *Identifying and Assessing Risks of Material Misstatement*. Specifically, paragraph 56 of that standard provides the auditor with guidance related to assessing risks of material misstatement but does not implicitly require the auditor to assess either inherent or control risk. We ask the PCAOB to consider whether a discussion of assessing control risk would better fit in that context.
- ▶ We suggest removing the presumptively mandatory requirement from the second sentence of paragraph 49. 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. *[Prescriptive requirements]*
- ▶ We recommend that the first sentence of paragraph 50 be revised as follows:

If the auditor *detects* misstatements that he or she did not expect when assessing the risks of material misstatement *detects*, the auditor should evaluate ...

Appendix 5: Evaluating Audit Results

- ▶ We believe that the objective in paragraph 2 is overly broad and does not adequately address the objective of the standard. Therefore, we believe the following would be a more appropriate objective for the proposed standard and recommend the Board consider revising paragraph 2 in such a manner: *[Objectives]*

The objective of the auditor is to evaluate the results of the audit to determine whether the audit evidence obtained is sufficient and appropriate to support the opinion on the financial statements.

- ▶ Paragraph 3b defines the term "misstatement." However, it is unclear whether the intent of the Board was to define "misstatement" or "material misstatement." We recommend that the Board consider the definition of misstatement from ISA 450, (Revised and Redrafted), *Evaluation of Misstatements Identified during the Audit* (ISA 450), paragraph 4(a), which states that a misstatement is "a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud." *[The relationship of the PCAOB standards to other auditing standards]*
- ▶ Paragraph 8 states that the nature, timing, and extent of the analytical procedures that should be performed during the overall review depend on the nature of the company and its industry. We do not believe this is generally the case in practice and also does not seem consistent with the requirement in paragraph 6, which is to perform overall analytical procedures to assess the auditor's conclusions and assist in forming an opinion on the financial statements. In most instances, such analytical procedures are similar to those performed during the risk assessment process. Therefore, we recommend that the proposed standard clarify the expectation of the auditor regarding the nature and extent of procedures to be performed in the overall review.
- ▶ Paragraphs 12 and 13 use the term "clearly trivial." We suggest that the proposed standard include language similar to the application guidance in paragraph A2 of ISA 450, which defines "clearly trivial" as follows: "Matters that are clearly trivial will be a wholly different (smaller) order of magnitude than established materiality, and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. When there is any uncertainty about whether one or more items are clearly trivial, the matter is considered not to be clearly trivial." By adding additional language such as this, we believe the auditor will be able to better understand what is meant by the term "clearly trivial" when accumulating and evaluating identified misstatements. *[Additional guidance]*
- ▶ Paragraph 14 states that "The auditor's accumulation of misstatements should include the auditor's best estimate of the total misstatement in the accounts and disclosures that he or she has tested, not just the amount of misstatements specifically identified." We suggest that the

Board provide additional guidance regarding what is meant by “best estimate” in this context and how the auditor would calculate a best estimate for all accounts and disclosures tested. [Additional guidance]

- ▶ Within paragraph 19 the words “detected in prior years” are used instead of “related to the prior year” as used in ISA 450 paragraph 11. We believe the ISA language provides better guidance for auditors because there may be misstatements detected in the current year that relate to the prior year. We also believe that the requirement does not accurately capture the requirements in Staff Accounting Bulletin 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, which provides guidance on how the effects of prior year misstatements should be considered in quantifying a current year misstatement. We believe the ISA was drafted to be accounting framework neutral and therefore does not clearly address the effects of the iron-curtain versus the roll-over method. However, we recommend that the PCAOB standards be clear in this regard. [The relationship of the PCAOB standards to other auditing standards]
- ▶ We believe that the discussion of bias and the requirement for the auditor to “assess” bias in paragraph 25 should be strengthened. In our view, the proposed standard does not address the fact that the indicators of management bias also may affect the auditor’s conclusion as to whether the auditor’s risk assessment and related responses remain appropriate, and whether the financial statements as a whole are free from material misstatement. The Board may find the discussion of bias in the financial statements addressed in ISA 700, *Forming an Opinion and Reporting on Financial Statements* (ISA 700), paragraph 12 and the application guidance noted in paragraph A2 helpful in this regard. [Additional guidance]
- ▶ Paragraph 28 states that “If the auditor concludes that the amount of an accounting estimate included in the financial statements is unreasonable or was not determined in accordance with the applicable accounting principles, he or she should treat the difference between the estimate and the closest reasonable estimate as a misstatement.” We suggest that this paragraph be placed in the section of the proposed standard titled “Accumulating and Evaluating Identified Misstatements” because the paragraph deals more with whether a misstatement exists in an accounting estimate rather than the potential for management bias.
- ▶ We believe that the requirement in paragraph 32 is more appropriately placed in the proposed standard, *Identifying and Assessing the Risks of Material Misstatement*. Paragraph 30 discusses the requirement to evaluate whether the accumulated results of auditing procedures and other observations affect the assessment of fraud risks and the need to modify the audit procedures to respond to those risks. We believe that a requirement for the auditor to assess the risks of material misstatement due to fraud throughout the audit is best linked with the requirements and guidance regarding the identification and assessment of those risks rather than in connection with the “after the fact” evaluation of audit results required by paragraph 30. [Integration of fraud guidance]
- ▶ We believe that paragraph 37 could be improved by including some language from paragraph 17b of ISA 700 and therefore recommend that the paragraph be edited as follows: [The relationship of the PCAOB standards to other auditing standards]

If the auditor has not obtained sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement, the auditor should attempt to obtain further audit evidence.

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

- ▶ We recommend that the Board provide examples in support of paragraphs 10 and 11 for situations in which the Board believes it is appropriate to conclude that the amounts “differ significantly” or the financial statements have “changed significantly,” which would lead the auditor to reassess materiality or perform additional audit procedures as a result of differences in determined materiality amounts. [Additional guidance]

Appendix 7: Audit Evidence

- ▶ We suggest adding language from AU 326.02 to paragraph 2 to help clarify for the auditor what is meant by “other sources.” We recommend the following sentence be added to paragraph 2: [Additional guidance]

“Audit evidence is all the information, whether obtained from audit procedures or other sources, that is used by the auditor in arriving at the conclusions on which the audit opinion is based. Other sources may include audit evidence obtained from previous audits and a firm’s quality control procedures for client acceptance and continuance.”

- ▶ We recommend the following revision to the last sentence of paragraph 2:

Audit evidence consists of both information that supports and corroborates management’s assertions regarding the financial statements or internal control over financial reporting and any information that the auditor is aware of that contradicts such assertions.

- ▶ We do not believe that the objective as stated in paragraph 3 is clear. As written it appears to be nothing more than a slightly different formulation of the requirement in paragraph 4. In addition, the objective fails to capture the essence of the proposed standard, which is to design and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for the auditor’s opinion. The Board may find the language in paragraph 4 of ISA 500 (Redrafted), *Considering the Relevance and Reliability of Audit Evidence* (ISA 500), helpful in this regard. [Objectives].
- ▶ We recommend that paragraph 6 be revised as follows to be consistent with ISA 500 paragraph 5(b): [The relationship of the PCAOB standards to other auditing standards]

To be appropriate, audit evidence must be both relevant and reliable in providing support for the conclusions on which the auditor’s opinion is based.”

- ▶ We recommend that the Board consider providing additional guidance regarding the concept of relevance of audit evidence described in paragraph 7. Paragraph A27 of ISA 500 may be helpful in this regard. [*Additional guidance*]
- ▶ Paragraph A31 of ISA 500 indicates that generalizations about the reliability of certain kinds of audit evidence are subject to important exceptions. For example, information obtained from an independent external source may not be reliable if the source is not knowledgeable, or a specialist engaged by management may lack objectivity. We recommend that the Board consider adding similar language to paragraph 8. [*Additional guidance*].
- ▶ As currently written, the proposed standard is silent on the use of evidence from previous audits. We recommend that the Board consider incorporating some of the application guidance from ISA 500 paragraph A11, which states that "audit evidence obtained from previous audits may, in certain circumstances, provide appropriate audit evidence where the auditor performs audit procedures to establish its continuing relevance." [*Additional guidance*]

Appendix 8: Proposed Conforming Amendments to PCAOB Standards

- ▶ 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 AU section 350.23 to clarify that is not the intent.

- ▶ Paragraph 1 of the proposed 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." 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 proposed standard, *Audit Evidence*, and the related ISAs.