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Via E-mail: comments@pcaobus.org

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

**Re: PCAOB Release No. 2008-006, Rule Making Docket Matter No. 026, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk,* and *Conforming Amendments to PCAOB Standards***

Dear Members and Staff of the Public Company Accounting Oversight Board:

BDO Seidman, LLP welcomes this opportunity to comment on the PCAOB's *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk* (the proposed standards). Overall, we support these proposed standards that collectively update the PCAOB's interim standards to reflect the importance of the identification and assessment of risks and the resultant response to such assessed risks. While many firms have incorporated the enhanced risk assessment procedures into their methodologies as a result of the guidance provided within the AICPA's and the International Auditing and Assurance Standards Board's (IAASB) audit risk standards, we believe it is important for the PCAOB to also incorporate these risk assessment principles into their extant interim standards to promote consistently high auditor performance. We provide the following overall general comments, followed by our responses to the specific questions posed in the release.

***Convergence with IAASB International Auditing Standards***

As set out in the release, we support the convergence efforts already undertaken by the Board, including participation at various levels in the international standard setting process, and the inclusion of an appendix within the proposed standards that outlines the significant differences between the International Auditing Standards (ISAs) and the proposed standards to help auditors understand what is expected of them under each set of standards. The development of high quality standards that converge with the ISAs, where appropriate to do so, will promote the performance of high quality audits, especially for those audits performed on multinational entities. Additionally, convergence will have a positive impact on costs related to the development of a single audit methodology, and to updating training programs, audit manuals, and other firm guidance. These matters are particularly significant for firms that operate as part of an international network.

While we recognize the very important steps taken to date, we strongly encourage the Board to more fully engage in the standard setting process with both the IAASB and the AICPA, to ensure that the auditing standards are consistent to the fullest extent possible and only differ when necessary due to the nature of the audit of a public company. We believe each standard setter should use the ISAs as a starting point, and diverge from that guidance only when necessitated by any unique circumstances or laws and regulations related to auditing and reporting within their jurisdiction. In the circumstances where substantive differences are proposed, we support the identification and presentation of such differences (at a paragraph level) in an exhibit to assist practitioners in evaluating the impact of these differences on their audit methodology. In following such an approach, we suggest that all standards include an objective that is action-based, such that the required procedures support the achievement of the objective. Since not all circumstances can be anticipated in a standard, the objective provides a reference point against which the auditor would assess whether in his or her professional judgment the objective of the standard had been met or whether additional procedures needed to be performed.

We noted that in some instances, application guidance from the ISA had been elevated to a requirement in the proposed standards. For example, in the proposed standard, Appendix 3, *Identifying and Assessing Risks of Material Misstatement*, paragraph 52(d) describes the procedures the auditor should perform in all circumstances related to specific inquires about fraud with accounting and financial reporting personnel, whereas the ISA (ISA 240 paragraph A16) provides guidance that permits the auditor to use professional judgment in determining to whom in the entity it is most appropriate to address fraud inquiries. In instances such as this, where guidance has been elevated to a requirement or where requirements are not carried forward from the ISA guidance to the proposed standard, we believe that the underlying rationale should be provided in an appendix.

***One Risk Assessment Process***

The top-down risk-based approach, as provided for in Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements (AS 5*), is an essential element in assessing the risk of material misstatement, not only for an integrated audit but also for a financial statement only audit. The same risk assessment process is followed in both instances, whereby the auditor obtains an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement starting at the entity level. Accordingly, we encourage the PCAOB to integrate this guidance into the risk assessment standards to facilitate this approach to risk assessment.

Additionally, we suggest that the guidance included within AS 5, paragraphs 34 through 39, about the auditor's understanding of the significant processes, identification of points within the process where a risk of material misstatement exists, and identification and assessment of the design of controls within those processes to address those risks, be included within the proposed standards, and deleted from AS 5. These procedures relate to a risk assessment process that should be performed regardless of whether the engagement is an integrated audit or a financial statement only audit.

Moreover, we noted that much of the guidance related to the risk assessment with respect to an integrated audit as set out in the proposed standard would be included in both AS 5 and the PCAOB's suite of risk assessment standards. Since the risk assessment process should be the same regardless of whether the audit is integrated or financial statement only, we believe that the risk assessment guidance only needs to be included within these risk assessment standards and that AS 5 should only include those additional procedures necessary to complete the audit of internal control over financial reporting.

***Integration of Fraud Guidance***

We support the integration of the fraud guidance from the interim standards into the proposed standards, as we believe it emphasizes that the fraud procedures are not "add-on" procedures but rather an essential element to the risk assessment process. However, we noted that certain paragraphs from the PCAOB interim standard, AU sec. 316, were deleted and not included within the proposed risk standards, specifically (1) PCAOB interim standard AU sec. 316.77, item c, which deals with the discussion of misstatements with management at least one level above those involved that may be material to the financial statements and that are or may be the result of fraud and (2) item d of that paragraph, which provides that, if appropriate, the auditor should suggest that the client consult with legal counsel. We believe that this guidance should not be deleted and also recommend that a full review of the deleted fraud guidance, as set out in Appendix 8, be performed to ensure that no other relevant paragraphs have been unintentionally deleted.

***Scalability***

We support the efforts made to introduce the concept of scalability into the proposed standards and encourage the PCAOB to enhance that guidance. The recent issuance of the publication, *Staff Views – An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit Of Financial Statements: Guidance for Auditors of Smaller Public Companies*, illustrates various opportunities to scale the audit throughout the risk assessment process. We recommend that the appropriate guidance from this publication be incorporated in the proposed standard, similar to the way the fraud guidance has been interwoven, to provide an "integrated" approach to the risk assessment process.

***Effective Date***

While no effective date was proposed in the release, we encourage the PCAOB to ensure that sufficient time is provided for firms to incorporate the proposed standards into their audit methodology and training programs so that implementation supports the goal of high quality audits.

**Responses to Questions Posed in the Release**

**Audit Risk in an Audit of Financial Statements**

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

   Overall, we agree with the description of audit risk and its component risks within the proposed standard; however, we suggest including the following phrase at the end of the first sentence in paragraph 3, "and whether any material weaknesses exist as of the date of management's assessment" to recognize that audit risk in an integrated audit must also include this separate but related consideration.

   Additionally, we believe that the guidance provided with respect to the risk of material misstatement at the financial misstatement level, included in paragraph 6, should be expanded to include guidance similar to that included in ISA 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment* (ISA 315), paragraphs A98 – A101. This guidance provides a description of the types of risk that are considered to be financial statement level risks and emphasizes that financial statement level risk may be especially relevant when considering the risks of material misstatement arising from fraud.

**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?**

We agree that it is reasonable and appropriate to include the matters listed in AS 5 paragraph 6 within paragraph 7 of Appendix 2 of the proposed standard, since these factors are relevant to both an audit of internal control over financial reporting and to a financial statement only audit. As noted above, we believe the planning and risk assessment process should be the same for both audits.

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

While the overall direction regarding multi-location engagements is reasonable and appropriate, we suggest that guidance regarding multi-location scoping decisions from AS 5 (e.g., paragraphs B10 through B16) be moved to the proposed standard, since the same scoping decisions would apply to either an integrated audit or an audit of financial statements.

Additionally, we believe that all risk assessment guidance should be included within one standard, and as such, suggest removing that guidance from AS 5 and including it within this proposed standard to support the concept that there is only one risk assessment process.

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

In addition to our response above, we also believe that it may be helpful to provide additional direction on the unique issues surrounding multi-location engagements that apply within a group audit situation, and as such recommend including within this standard the applicable guidance from ISA 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors),* specifically guidance relating to determining the type of work to be performed on the financial information of components, both significant and not significant.

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

We have the following suggestions to improve the clarity of the responsibilities of the engagement partner for planning and supervision. First, we recommend the PCAOB move paragraph 3 of the proposed standard from the "Objective of the Auditor" section of the proposed standard and incorporate it as a requirement under the "Planning an Audit" and "Supervision" sections of the standard. We believe that the objective of each individual standard should focus the auditor on the desired outcome of the standard, while being specific enough so that the auditor (1) understands what needs to be accomplished and how, and (2) can decide whether the objective has been met or whether additional audit procedures need to be performed. The current structure of the objective, as stated in paragraph 3, is not an objective of the auditor, but rather a required procedure.

Additionally, we believe that the proposed standard would benefit from the inclusion of paragraphs A5 and A9 of ISA 300, *Planning an Audit of Financial Statements*, which provides a further description of the role of the engagement partner and other key members of the engagement team.

Further, the first sentence of paragraph 21 states that the partner and team members "should make themselves aware" of certain procedures to be followed when there are differences of opinion among the team. This phrase is unclear, and as such we recommend the PCAOB provide specific guidance about the steps to be taken in this circumstance either within this proposed standard and/or within the quality control standards.

## <u>Identifying and Assessing Risks of Material Misstatement</u>

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

We believe that the proposed standard could better describe the auditor's responsibilities for performing risk assessment procedures and provide the following suggestions for improvement. As noted earlier, we support convergence with the ISAs and the development of objectives that focus on desired outcomes. Accordingly, we suggest revising the objective of this proposed standard to conform to ISA 315 which states:

> "The objective of the auditor is to identify and assess the risks of material misstatement whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement."

Additionally, the definition in paragraph 4 of significant risk differs from the definition in ISA 315 in that it does not refer to "identified and assessed" risks or "auditor's judgment." We believe each of these concepts is integral to the concept of significant risk, and as such, we recommend revising the proposed definition as follows (with additions to the proposed standard shown in italics and deleted text as strikethrough text), to emphasize the direct link between assessment of risk and planned procedures, based on the auditor's judgment:

> "Significant risk – *An identified and assessed* risk of material misstatement that ~~is important enough to~~ *in the auditor's judgment* ~~to~~ requires special audit consideration."

Further, in some instances we noted that application guidance from ISA 315 was elevated to a presumptive requirement in the proposed standard; for example, paragraph 6 of the proposed standard states the auditor's risk assessment procedures *should* include certain matters, whereas the related guidance in ISA 315, paragraph 6 includes this as application guidance. We recognize that some of the differences between the ISA guidance and the proposed standards are provided in Appendix 10; however, it is not complete, and at times the judgments supporting the conclusions are not apparent. As such, we suggest providing a more robust description of differences between the ISAs and the proposed standards to enhance the auditor's understanding of the reasons for the differences and whether the intention is to change auditor behavior from what it would be under the ISAs.

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?**

We agree that the additional procedures in paragraph 13 seem reasonable and appropriate for the auditor to consider when obtaining an understanding of the company and its environment for audits of issuers. Additionally, we believe that these procedures should not be a requirement, but rather should provide guidance about the types of procedures that may be performed to satisfy the presumptive requirement included in paragraph 9, which states the "auditor's understanding of the company <u>should</u> include …the nature of the company…"

In addition, we are uncertain about the meaning of the term "should consider" specifically with respect to the expected auditor action and related documentation to support such consideration. Accordingly, we suggest replacing the phrase "should consider" with the phrase "may consider." Since this guidance supports the requirement to understand the nature of the company, we believe that this structure would provide appropriate guidance.

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?**

   Overall, we agree that the new requirement, included in paragraph 26 of Appendix 3, to assess (1) whether management's philosophy and operating style promotes effective internal control over financial reporting, (2) whether sound integrity and ethical values, particularly of top management, are developed and understood, and (3) whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control, is reasonable and appropriate. As described in Appendix 9 of the release, this new requirement is aligned with the requirements in AS 5, specifically paragraph 20; however, we noted that one of the factors from paragraph 20 of AS 5, relating to whether the company takes actions to reduce or mitigate the incentives and pressures on management that would provide a reason to misstate the company's financial statements, was not included within the proposed standard, even though it seems applicable to both an integrated audit and a financial statement only audit. We believe that the proposed standard would be strengthened by the inclusion of this consideration, which furthers the PCAOB's goal of integrating the auditor's consideration of fraud risk factors within the risk assessment process.

   While we support aligning the risk assessment process from AS 5 with these proposed standards, we recognize that the amount of audit attention devoted to understanding whether controls are appropriately designed and implemented will differ depending on various factors, including whether the audit strategy contemplates more testing of controls (e.g., in an integrated audit), the company's internal control is more complex, or the company's controls have changed significantly. This concept is clearly presented in Appendix 9; however, the proposed standard does not include such a discussion, which we believe would clarify how this requirement is intended to be implemented in differing circumstances. For this reason, we recommend including this "application" guidance as part of the proposed standard.

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

   We support including the additional direction regarding the period-end reporting process for audits of financial statements only that is included in paragraph 32 of this proposed standard. This guidance aligns with both AS 5 and ISA 315 (paragraph A77) and, in addition to strengthening the PCAOB's interim standards, would also promote convergence with the ISAs, which we support.

   The note to paragraph 32 states that in an integrated audit, the auditor's procedures for obtaining an understanding of the company's monitoring activities might be performed in conjunction with the evaluation of entity-level controls. We believe that auditors in each type of engagement would obtain this understanding as part of their top-down approach to assessing risk, whereby the auditor obtains an understanding of the entity level controls first to understand the top level controls that may mitigate the risk of material misstatement before assessing the lower level controls. For this reason, we suggest revising the note to recognize the applicability of the top-down approach to both an integrated and financial statement only audit.

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?**

    Overall, the requirements and direction seem appropriate; however, we believe this guidance could be strengthened through the addition of guidance that describes the benefits of a walkthrough in assessing the design and implementation of controls, similar to that included in paragraph 37 of AS 5. Additionally, the guidance in paragraph 39 of AS 5, relating to the use of probing questions in gaining a sufficient understanding of the process, is an essential procedure in gaining the necessary understanding of internal control over financial reporting as part of a robust risk assessment, and as such should be incorporated in the proposed standard.

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

    We agree that the key engagement members should participate in the discussion regarding the risks of material misstatement as part of the risk assessment process, and that the key engagement team members include the engagement partner and all engagement team members who have significant engagement responsibilities.

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

The discussion of significant risks as set out in paragraph 63 of the proposed standard is consistent with that in ISA 315 and we believe provide sufficient direction. However, see our response to question 6 above regarding changes we believe are necessary to the definition of significant risk.

**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?**

No additional documentation direction is necessary beyond that already included within Auditing Standard No. 3.

**The Auditor's Responses to the Risks 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?**

We believe that the proposed standards should only include guidance related to testing controls in a financial statement only audit, with the incremental testing necessary to meet the objective of tests of controls in an integrated audit maintained in AS 5. In this way, the proposed standards would not unnecessarily repeat guidance contained elsewhere (AS 5) and more clearly set out the requirements for testing controls in the financial statement only audit. We agree with the PCAOB's view, as set out in Appendix 9 of the release, that the basic principles for designing and performing tests of controls are the same for the audit of internal control over financial reporting and the audit of the financial statements. Accordingly, we believe that this guidance in the proposed standard is appropriate. However, we believe it would clarify the incremental procedures necessary to support the auditor's opinion on internal control over financial reporting if this incremental guidance were included solely in AS 5.

Additionally, we believe footnote 14 to paragraph 18, which provides guidance about the "period of reliance" with respect to testing controls in a financial statement audit, should be included within the body of the standard. Further, including implementation guidance similar to ISA 330, *The Auditor's Responses to Assessed Risks* (ISA 330), paragraph A32, which 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, would help clarify the concept.

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

See our response to Question 14 above.

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

Overall, we support the emphasis in the proposed standard, which provides direction that is intended to lead auditors to design audit procedures that are based on and address the risks of material misstatement. However, we note that the guidance in Appendix 4, paragraph 45, which requires the auditor to perform substantive procedures, *including tests of details* [emphasis added], to respond to significant risks, does not appropriately consider that in certain circumstances it may not be possible to perform such tests of details (e.g., when a client transacts substantial business through EDI) or that the most effective way to address the risk may be accomplished through a combination of tests of controls and substantive procedures. These considerations are consistent with ISA 330, paragraph 22, which states:

> "When the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of detail."

**<u>Evaluating Audit Results</u>**

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

We support the PCAOB’s approach to consolidate into one standard the requirements and direction regarding the auditor’s responsibilities regarding the evaluation of audit results. However, the objective as stated does not provide the appropriate context with which to evaluate whether the procedures performed achieve the desired outcome. In ISA 450, *Evaluation of Misstatements Identified During the Audit* (ISA 450), for example, the objective of the auditor is to evaluate (a) the effect of the identified misstatements on the audit, and (b) the effect of uncorrected misstatements, if any, on the financial statements. This objective provides a benchmark against which auditor performance can be gauged with respect to evaluating identified misstatements. We suggest using the ISA objective as a starting point in developing a broader objective that would encompass the range of topics included within the standard as set out in paragraph 5 of Appendix 5.

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

To improve the direction in this area, we suggest enhancing the guidance in paragraph 13 of Appendix 5 by further clarifying that “clearly trivial” is not another expression for “not material” as set out more fully in ISA 450, paragraph A2. Although this term is generally understood to mean matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstance, we believe the clarity of the proposed standard would be enhanced by including this definition.

Another area where we believe the direction regarding misstatements can be improved is with respect to the use of the term “identified misstatements.” Although we understand this term to represent known or factual misstatements, this term is not defined and may also be understood to include projected misstatements and misstatements related to accounting estimates that are outside of a reasonable range. ISA 450, paragraph A3 distinguishes between factual misstatements, judgmental misstatements, and projected misstatements, and defines each. We believe that since the intent of the PCAOB’s standards is the same as that set out in the ISA, the PCAOB should use the terms set out in ISA 450, which we believe improves clarity and provides for the use of consistent terminology in auditing guidance of different standard setters when no difference in meaning is intended.

**19. Are the requirements and direction regarding the evaluation of the results of the integrated audit appropriately aligned with Auditing Standard No. 5?**

As we stated in the front part of the letter, we agree that all guidance relating to the risk assessment process that is applicable to both a financial statement only audit and an integrated audit should be included within these proposed standards, with conforming amendments made to AS 5 to eliminate redundancy. Further, we suggest removing guidance that solely relates to AS 5 from these standards so that any guidance specific solely to an audit of internal control over financial reporting would be included in AS 5.

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

**20. Are the requirements and direction in this standard appropriately aligned with the concept of materiality as described in the courts' interpretation of the federal securities laws?**

The concept of materiality as set out in paragraph 2 of the proposed standard appears appropriately aligned with the courts' interpretation of the federal securities law, which recognizes that materiality is developed in reference to a "reasonable person" relying upon the report. However, we note that paragraph 7 of the proposed standard refers to a reasonable investor when considering whether certain accounts or disclosures may carry more weight with financial statement readers. The use of the term "reasonable investor" is not internally consistent nor is the term used in the ISAs, which uses the term "user of the financial statements." For these reasons, we suggest changing the term to "financial statement users."

**21. Does the proposed standard sufficiently and clearly describe the auditor's responsibilities regarding (a) establishing an appropriate materiality level for the financial statements as a whole and (b) establishing a lower materiality level or levels for particular accounts or disclosures? If not, what additional direction is needed?**

We believe the proposed standard appropriately describes the auditor's responsibilities.

**22. Is the use of the term "tolerable misstatement" in the proposed standard appropriate and sufficiently clear?**

We believe that since the term "tolerable misstatement" has the same meaning as the term "performance materiality" in ISA 320, *Materiality in Planning and Performing an Audit*, the PCAOB should also use the term "performance materiality." Using the same terms when there is no difference in meaning will enhance auditor performance, especially in audits performed internationally. Additionally, this same term has been used by the AICPA Auditing Standards Board in the redrafting of its suite of audit risk standards, which has recently been issued for exposure.

**Audit Evidence**

**23. Does the proposed standard clearly describe the principles necessary for evaluating the sufficiency, relevance, and reliability of audit evidence?**

Overall, the proposed standard clearly describes the principles necessary for evaluating the sufficiency, relevance, and reliability of audit evidence; however, we believe the objective as stated is overly broad and should focus on how to design and perform audit procedures to obtain sufficient, appropriate audit evidence, similar to ISA 500, *Considering the Relevance and Reliability of Audit Evidence*, rather than on obtaining audit evidence sufficient to support the opinion.

**24. Are the auditor's responsibilities regarding the authentication of documents reasonable and appropriate?**

We believe that these responsibilities are reasonable and appropriate.

**25. Are the requirements and direction related to selecting items for testing appropriate and clear?**

We recommend adding guidance regarding the concept that the selective examination of specific items, particularly if those items are selected based on the auditor's belief that they are more likely to contain a misstatement, may provide the auditor with some audit evidence concerning the remainder of the population.

**26. Are the five categories of assertions in this standard sufficient or should they be expanded? If so, how would such expansion affect auditor performance?**

While we recognize that the ISAs include 13 types of assertions within 3 broad categories that include transaction-based assertions, assertions about account balances at the period end, and assertions about presentation and disclosure, we do not believe that it is necessary to align directly to the ISA, since the proposed standard would not preclude auditors from using the 13 categories as set out in the ISAs.

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We appreciate your consideration of our comments and suggestions, and would be pleased to discuss these with you at your convenience. Please direct any questions to Wayne Kolins, National Director of Assurance at 212-885-8595 (wkolins@bdo.com) or Susan Lister, National Director of Audit Policy at 212-885-8375 (slister@bdo.com ).

Very truly yours,

*/s/ BDO Seidman, LLP*

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