

March 2, 2010

Public Company Accounting Oversight Board
Office of the Secretary
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: Request for Public Comment on Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards (PCAOB Release No. 2009-007, December 17, 2009, Rulemaking Docket Matter No. 026)

Deloitte & Touche LLP appreciates the opportunity to respond to the request for comments from the Public Company Accounting Oversight Board (the "PCAOB" or the "Board") on its *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards* (PCAOB Release No. 2009-007 ("Release"), December 17, 2009, PCAOB Rulemaking Docket Matter No.026) (the "Proposed Standards").

We continue to support the PCAOB's efforts to improve its auditing standards related to the auditor's identification of, and responses to, risk in the conduct of an audit. The risk assessment standards contain many of the core principles underlying the audit and the PCAOB has advised that they will be used as a foundation for the development of other auditing standards. Given their importance to the auditing standards as a whole, we believe transparency in the process undertaken by the PCAOB to develop the risk assessment standards is essential. To that end, we commend the PCAOB for its decision to revise and re-expose for public comment the Proposed Standards following their original proposal in 2008. We note several improvements to the Proposed Standards arising from the revisions made by the PCAOB. However, there are certain elements of the Proposed Standards with which we continue to be concerned and therefore we have carried forward certain comments from our comment letter on the original proposed standards. We have also included new comments based on revisions proposed by the PCAOB. Our letter contains Overall Comments and Specific Comments on Proposed Standards by Paragraph.

We welcome an opportunity to further discuss these matters with the Board and the staff. Dialogue with commenters as the Proposed Standards are evaluated and changes are considered will facilitate a more complete understanding of the comments, full consideration of related implications, and, we believe, will ultimately improve the final standards and the auditor's ability to implement them effectively and efficiently. If you have any questions or would like to discuss

these matters further, please do not hesitate to contact John Fogarty at (203) 761-3227. We thank you for your consideration of these matters.

Very truly yours,

/s/ Deloitte & Touche LLP

cc: Daniel L. Goelzer, Acting PCAOB Chairman
Bill Gradison, PCAOB Member
Steven B. Harris, PCAOB Member
Charles D. Niemeier, PCAOB Member
Martin F. Baumann, Chief Auditor and Director of Professional Standards

Mary L. Schapiro, SEC Chairman
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I. Overall Comments

We agree with the Board’s statement that these Proposed Standards “...address many fundamental aspects of the audit process and are expected to serve as a foundation for future standard setting...” Given the foundational nature of the Proposed Standards and as the PCAOB is embarking on its active standard-setting agenda, we would like to take this opportunity to provide more general input to the PCAOB on certain overarching aspects of its standard-setting processes, including the structure and format of its auditing standards.

Within the context of our general comments on the standard-setting processes, we have provided examples of our points in relation to the Proposed Standards. Our Overall Comments include feedback on:

- A. Transparency in the standard-setting process
- B. Drafting conventions employed by the PCAOB in its auditing standards, including:
 - 1. The structure of standards and releases
 - 2. The use of terminology throughout the auditing standards
 - 3. The application of Rule 3101
 - 4. Documentation requirements
 - 5. The integration of requirements and guidance related to multi-location engagements in the Proposed Standards
- C. Convergence with other auditing standard-setting bodies
- D. Standard-setting agenda, timetable, and effective date

A. Transparency in the standard-setting process

The re-exposure of the Proposed Standards is one of several steps that we have noted the PCAOB has taken towards increasing the transparency of its standard-setting process. We are encouraged by the PCAOB’s objective, stated in its 2009 – 2013 Strategic Plan, to “maintain a program to obtain input from investors, public companies, registered public accounting firms, the academic community and other interested parties on the PCAOB’s proposals and emerging issues related to its work” through “[e]nhanc[ing] the transparency of standard setting and other rulemaking initiatives by developing clear releases and other statements describing the objectives, methods and intent of each proposal in a manner that allows the investing public and other interested parties to understand the import and effect of the proposal and facilitates meaningful public comment.”

We strongly support the inclusion of Appendix 9, *Additional Discussion of New Proposed Auditing Standards and Comments on Original Standards Proposed in October 2008* (“Appendix 9”), and Appendix 10, *Comparison of the Objectives and Requirements of Proposed Auditing Standards to the Analogous Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board of the American Institute of Certified Public Accountants* (“Appendix 10”), in the Release. We believe the inclusion of these appendices marks a positive step for the PCAOB in meeting its 2009 – 2013 Strategic Plan objectives for transparency. Appendices such as these provide an opportunity for the PCAOB to clearly describe the rationale for the structure and content of its Proposed Standards. At the same time, we believe that

transparency would increase and usefulness would improve if a greater level of detail were provided in these appendices. In particular, the appendices should set forth the reasoning for the differences between the original proposed standards and the Proposed Standards. Importantly, the appendices should clearly describe the details and rationale for the differences between the Proposed Standards and the risk assessment standards in the International Standards on Auditing (ISAs) of the International Auditing and Assurance Standards Board (IAASB) and the Statements on Auditing Standards (SASs) of the Auditing Standards Board (ASB), which have been implemented by many public accounting firms.

Board Member Niemeier indicated during the open meeting to approve the Proposed Standards for public comment, “[w]e should use our releases to explain what we want to change. This would help auditors understand our expectations.”¹ We agree with this statement and we believe that the Release, including Appendices 9 and 10, could have more clearly articulated the expected changes in practice arising from the Proposed Standards.

For example, Appendix 9 describes a change made to the discussion of the concept of materiality in Appendix 3, *Consideration of Materiality in Planning and Performing an Audit*. In the PCAOB’s existing standard and in the original proposed standard of the same name, the concept of materiality was linked to FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*. In the Proposed Standards, the concept of materiality has instead been linked to case law and the Supreme Court’s articulation of the concept of materiality. In Appendix 9, only very limited explanation is provided for the revision, and it does not appear that the change arose due to comments received on the original proposed standards. More importantly, there is no indication of whether the PCAOB expects any change in practice from this revision, or whether it views the concept of materiality as being significantly different between case law and the applicable accounting frameworks used by issuers whose financial statements are being audited in accordance with the PCAOB’s standards.

We also note that Appendix 10 is incomplete for several reasons:

- The appendix provides a high-level comparison between the Proposed Standards (in full) and the objectives and requirements sections of the IAASB and ASB’s respective risk assessment standards. This results in an “apples to oranges” comparison, as it excludes the application material that is included in the IAASB and ASB’s standards. Such application material is considered an essential part of the IAASB and ASB standards. Auditors are required by the IAASB and ASB standards to have an understanding of the entire text of a standard (including the application material) so as to be able to apply the related requirements properly. For future such appendices, we believe a more comprehensive comparison of complete standards (i.e., objectives, requirements, and guidance, including application material) would be appropriate.
- Even for the components of the ISAs that are covered in Appendix 10 (i.e., objectives and requirements), the appendix does not include all differences between the Proposed Standards and the standards of the IAASB and ASB.
 - For example, the wording of the second bullet of paragraph 10 in Appendix 2, *Audit Planning and Supervision* (“Appendix 2”), differs from the corresponding wording in ISA 300, *Planning an Audit of Financial Statements* (“ISA 300”) paragraph 9. In

¹ See Statement by Board Member Charles D. Niemeier at the December 17, 2009, open Board Meeting on <http://www.pcaobus.org>.

the ISA, the auditor is required to include in the audit plan a description of “the nature, timing and extent of planned further audit procedures at the assertion level.” In paragraph 10 of Appendix 2, the auditor is required to include in the audit plan a description of “the planned nature, timing and extent of tests of controls and substantive procedures” without mention of doing so at the assertion level. This difference is not discussed in Appendix 10 and therefore it is unclear (1) whether a difference is intended by the PCAOB and (2) what expected difference in practice, if any, is intended as a result of the divergence.

- For example, paragraph 16 of Appendix 6, *Evaluating Audit Results*, differs from the corresponding wording in paragraph 7 of ISA 450, *Evaluation of Misstatements Identified During the Audit*. Paragraph 16 of Appendix 6 indicates that if management has corrected an account or disclosure, the auditor “should evaluate management’s work to determine whether the corrections have been appropriately recorded and whether uncorrected misstatements remain.” Paragraph 7 of ISA 450 indicates that the auditor “shall perform additional audit procedures to determine whether misstatements remain.” This difference is not discussed in Appendix 10 and therefore it is unclear (1) whether a difference is intended by the PCAOB and (2) what expected difference in practice, if any, is intended as a result of the divergence.
- There is no overall commentary from the PCAOB about whether the differences included in Appendix 10 are, in the PCAOB’s view, the only substantive, intended differences between the ISAs and SASs and the Proposed Standards, or whether there are other differences that the PCAOB has chosen not to highlight but for which they expect a difference in practice.

As noted above, we believe comparative appendices can be extremely useful in highlighting the intended differences between the PCAOB’s proposed standards and the analogous standards of the IAASB and ASB.

In addition, and equally important, these appendices should be used to describe in detail the differences between the existing PCAOB standard and the proposed PCAOB standard. This will contribute to a higher level of audit quality, where the auditor can clearly determine what actions to take that are different or additional when performing the audit in accordance with the standards of the PCAOB. We also recommend that as the PCAOB continues to move forward with its standard-setting agenda it would be useful when seeking public consultation on its proposed standards to provide “marked changes” versions, showing changes from the existing PCAOB standards. This will enable commenters to quickly identify and understand the changes proposed by the PCAOB, particularly with respect to significant conforming amendments (such as those proposed with respect to AU 316, *Consideration of Fraud in a Financial Statement Audit* (“AU 316”)). Such information will enable the PCAOB to highlight in the information accompanying the proposed standards (1) the reasons for those changes and (2) the expected changes in practice.

In addition to the transparency initiatives manifested in the re-exposure of the Proposed Standards, we also recognize other activities the PCAOB has undertaken to more holistically address transparency in its standard-setting processes. Most notably, the organization and structure of the PCAOB’s last Standing Advisory Group (SAG) meeting in October 2009, which included a discussion of comments received on the original proposed risk assessment standards, demonstrated the PCAOB’s efforts to foster a two-way dialogue with the SAG about auditing standards while the standards are in the process of being developed. We also encourage the PCAOB to consider increasing the use of task forces comprised of audit practitioners for future standard-setting

activities; similar to the task force used when developing the PCAOB's *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*.

B. Drafting conventions employed by the PCAOB in its auditing standards

We remain concerned about the drafting conventions used in the PCAOB's auditing standards, including, in particular, the use of terminology. We believe improvements need to be made in order to more clearly communicate the PCAOB's expectations of auditors, enhance the usability of the standards, and improve their application. It is imperative for auditors to have a clear understanding of the standards in order to be able to apply them. We believe the PCAOB could significantly improve the understanding and application of its standards in several ways, discussed below.

1. Structure of standards and releases

In general, we find the Proposed Standards to be cumbersome and difficult to follow. One cause of this reaction is the placement of requirements in any and all areas of a standard, or in some cases, within appendices or the Release accompanying the standard. Such an approach may lead to reduced audit quality as auditors have to spend time conducting a comprehensive search through sizable Releases to ensure they have documented compliance with each "should" and "must" in the standard itself as well as the accompanying Release.

Within a standard, specific requirements are set forth in multiple locations including in a Note, Appendix or a footnote. We believe that the "peppering" of requirements throughout a standard is not the most effective way of identifying and communicating requirements to auditors.

The intention of a "Note" is unclear. Some readers may think they are of less importance (i.e., like a footnote or an aside). Other readers may believe that they are being used to highlight significant points. It is difficult to determine the reasoning and circumstances under which Notes are employed by the PCAOB in its standards. Unless the PCAOB intends to draw specific attention to the content of a Note, we believe it would be clearer to include the content of Notes within the text of the underlying paragraph itself.

In addition, we believe it is inappropriate and confusing for the PCAOB to use "should" and "must" statements outside of a standard. For example, in the Release accompanying the Proposed Standards, Appendix 9 discusses the requirement included in Appendix 6, *Evaluating Audit Results* for the auditor to identify necessary disclosures for the company's financial statements. We agree with the requirement, but page A9-30 of the Release indicates that "[t]his requirement **should** prompt auditors to be more thoughtful and thorough in their approach to testing and evaluating disclosures." Rule 3101 *Certain Terms Used in Auditing and Related Professional Practice Standards* ("Rule 3101"), which we discuss further below, sets forth the use of "should" and "must," and their use in the Release as described above is confusing. We are unsure whether the auditor now has an incremental and presumptively mandatory obligation to be "more thoughtful and thorough."

Overall, we believe a clearer approach would be to use a structure similar to the ISAs, with requirements:

- Only included within a proposed standard and not included in a Release or Appendices accompanying the proposed standard;

- Clearly identified in accordance with PCAOB Rule 3101;
- Properly labeled and included in one location within the standard and followed by clearly labeled guidance.

We believe that the ISA structure provides a much clearer orientation to objective, requirement, and guidance so that the auditor can more easily locate and understand the requirements and implement the required auditor actions. We do not see how the structure of the PCAOB standards enhances readability or understanding in comparison to the ISA structure, and are in fact concerned that readability and understanding may be diminished by the PCAOB's structure. To the extent the PCAOB believes that its structure is more understandable and clearer than the ISA structure, it would be beneficial to communicate its rationale to the users of its standards, including addressing the specific concerns we have highlighted.

2. *Use of terminology throughout the auditing standards*

We continue to have several concerns about the terminology employed in the Proposed Standards. Because the terminology decisions made for the purposes of the Proposed Standards will affect future standard-setting activities, the finalization of the Proposed Standards is the appropriate time to develop a set of guidelines for the PCAOB to follow for using certain terms (such as “assess,” “determine,” “establish,” and “evaluate”). Such guidelines should also address the appropriate circumstances when individual terms should be used (e.g., establishing the circumstances under which it would be appropriate to use “determine” versus “evaluate” versus “conclude”), for using the present tense (i.e., when providing a statement of fact and not when describing a required auditor action in accordance with Rule 3101), and for using conditional language such as “ordinarily” and “usually.” These guidelines should be consistently employed in drafting standards so that auditor's performance requirements and expectations are clear. In developing and applying such guidelines in the standard-setting process, the Board should consider the implications of the language chosen, including the resulting audit performance intended and the related documentation requirements. Clear requirements and expectations will result in an improvement in audit quality.

Our concerns relating to terminology in the Proposed Standards fall into three principal categories:

- a. It is difficult to determine whether differences in terminology with the ISAs represent intended differences in the application of requirements. For example,
 - Appendix 4, *Identifying and Assessing Risks of Material Misstatement* (“Appendix 4”), defines “significant risk” as “a risk of material misstatement that requires special audit consideration.” In ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, the definition of “significant risk” is “[a]n identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.” The PCAOB's proposed definition does not refer to “identified and assessed” risks, but rather only refers to “risks.” The resulting implications are unclear, particularly as the difference in the definitions of the term is not addressed in Appendix 10. The concept of the auditor's risk assessment process is that the auditor identifies and then assesses significant risk, and then plans the audit procedures according to the “identified and assessed” risks. To remove these descriptors from the definition results in the auditor's risk assessment process apparently becoming disconnected from the planned audit procedures and is

contrary to the fundamental premise that the auditor's risk assessment forms the basis for the auditor's procedures. We believe the definition of "significant risk" should use the phrase "identified and assessed" risk. If the PCAOB decides not to use the phrase, we would like to understand whether the PCAOB believes the difference in terminology represents a substantive difference, and, if so, an explanation of the purpose of the difference should be provided in Appendix 10.

- Appendix 6, *Evaluating Audit Results*, includes a requirement in paragraph 3 for the auditor to "take into account all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements." ISA 330, *The Auditor's Responses to Assessed Risks*, paragraph 26 contains the exact same requirement, but instead of using "take into account" the auditor action is to "consider." This is another example of a difference in terminology with the ISAs, where the impact is unclear. We have concerns about the meaning and intended action that is meant to result from a requirement to "take into account", which we discuss further below, and additionally we are not clear what level of documentation is expected to support fulfillment of such a requirement. In addition to these general concerns, the rationale for the difference between the Proposed Standards and the ISAs is not provided in Appendix 10; therefore, we are unable to determine whether a difference in practice is in fact intended.

There are many other examples throughout the Proposed Standards of use of different terminology than the corresponding ISA paragraph(s) where the differences are neither noted nor explained as intending to mean something different. One area of specific concern regarding these wording changes is the impact in situations where a non-U.S.-based auditor familiar with, and experienced in, applying the ISA requirements is required to apply the standards of the PCAOB. Without a clear indication of whether the auditor is expected to perform different or incremental procedures because of the different language in what could reasonably be construed to be the same requirements, unnecessary confusion may ensue, which will potentially adversely affect audit quality, may result in more costly audits, and foster disagreements or misunderstandings when audits are inspected.

- b. Terminology changes made in the Proposed Standards may not have flowed through to other PCAOB auditing standards. For example,
 - In the conforming amendments detailed in Appendix 8 *Proposed Amendments to PCAOB Standards*, we note that certain terminology changes were made to other PCAOB standards, but we are concerned that these changes may not have been comprehensively implemented across the PCAOB standards. For example, a conforming amendment was proposed to paragraph 2 of AU 310, *Appointment of the Independent Auditor*, to replace the term "assistants" with "engagement team members." We agree with the proposed change. However, paragraph 2 of AU 310 includes a reference to AU 210, *Training and Proficiency of the Independent Auditor*. Paragraph 3 of AU 210 uses the term "assistant." There is no conforming amendment proposed to change "assistant" in AU 210. Paragraph 3 of AU 210 also uses the term "subordinates" in reference to engagement team members, but no conforming amendment is included to change that language.

- Similarly, the use of “auditor,” “engagement partner,” and “engagement team” seems inconsistent throughout the Proposed Standards as well as the existing standards. In Appendix 2, paragraph A2 defines “engagement partner” as a member of the engagement team, but paragraph 22 of that appendix states that “the auditor should properly supervise the members of the engagement team.” Further, paragraph 50 of Appendix 4 states that the “auditor should emphasize the following matters to all engagement team members.” In both these examples, it is unclear whether the “auditor” is intended to refer to a different individual than the “engagement partner.” The relationship of the “auditor” to the engagement team, and the resulting implication of these terminology differences, if any, is also not clear.

As the PCAOB continues over time to revise its auditing standards, we believe it would be useful to develop guidance regarding the terms used therein to assist individuals in understanding the different terms used and to recognize when there is meant to be equivalence between old and new terminology. In the context of the Proposed Standards, we recommend that the PCAOB implement conforming amendments to reconcile the language of its existing standards to the language of the Proposed Standards as completely as possible.

c. The intended meaning of certain auditor actions is unclear. For example,

- The Proposed Standards include a number of requirements for the auditor to “take into account” and to “consider” (e.g., Appendix 5, paragraph 9(b) and Appendix 4, paragraph 11, respectively). Appendix 9 indicates that the use of “take into account” is not new. However, we note that the term is used in very limited circumstances in the interim standards adopted by the PCAOB on April 16, 2003. The extent of its use in the PCAOB’s standards increased significantly when Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (“AS 5”) became effective. In describing the difference between a “consider” requirement and a “take into account” requirement, Appendix 9 explains that “consider” is used “only when referring to a requirement to consider performing an action or procedure.” “Take into account” seems to be used more broadly and with varying meanings in the Proposed Standard, which we believe will lead to confusion, inconsistent application, and as a result will likely have an adverse impact on audit quality.
 - For example, paragraph 55 of Appendix 4 states: “[w]hen evaluating management’s responses to inquiries about fraud risks, the auditor should take into account that management is often in the best position to commit fraud in determining when it is necessary to corroborate management’s responses.” The use of “take into account” in this sentence is confusing in three ways.
 - First, the statement itself that management is often in the best position to commit fraud is factual, and therefore we do not believe wording the statement as a presumptively mandatory requirement is appropriate.
 - Secondly, in accordance with the discussion in Appendix 9 about when it would be appropriate to use “consider,” it would seem that in this paragraph the intent is that the auditor is required to consider whether to perform an action or procedure (i.e., the auditor is determining whether it is necessary to corroborate), so if a requirement is warranted here,

“consider” may be more in line with the explanation provided in Appendix 9.

- Finally, we believe that, as drafted, the use of the phrase “take into account” questions the utility of discussing fraud with management because it may be management that committed the fraud. We believe that fraud can in fact come to light by asking direct questions of management.

We suggest that this sentence be revised along the lines of a similar statement in ISA 240, *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph A17: “Management is often in the best position to perpetrate fraud. Accordingly, when evaluating management’s responses to inquiries with an attitude of professional skepticism, the auditor may judge it necessary to corroborate responses to inquiries with other information.”

- For example, paragraph 9 of Appendix 2 indicates a list of items the auditor “should take into account” in establishing the overall audit strategy (e.g., the reporting objectives of the engagement). In the analogous ISA paragraph (ISA 300, paragraph 8), the required actions are detailed on an item-by-item basis (identify the characteristics; ascertain the reporting objectives, etc.). In this case, use of “take into account” in the Proposed Standards seems to be used as a substitute for clearer auditor actions (identify, ascertain, etc.), as well as for “consider.” We recommend that the requirements of paragraph 9 in Appendix 2 be aligned with the auditor actions specified in ISA 300, paragraph 8.

3. *The application of Rule 3101*

As expressed in our comment letter on the original proposed standards, we continue to be concerned with how the Proposed Standards are drafted in light of Rule 3101 and the impact of such drafting on auditor performance. We believe the Board should evaluate its application of Rule 3101 in the Proposed Standards in light of intended auditor action.

Under the Board’s Rule 3101, the auditor is required to fulfill specific responsibilities within an auditing standard based on use of the words “must” or “should” (i.e., an “unconditional” or a “presumptively mandatory” responsibility, respectively).² In order for the auditor to demonstrate that he or she has fulfilled these responsibilities, and to comply with Auditing Standard No. 3, *Audit Documentation* (“AS 3”), he or she must have appropriate documentation within the working papers demonstrating what procedures were performed relative to each instance of a “must” or a “should.”

² PCAOB Rule 3101, sets forth three degrees of auditor responsibility based on the word usage in PCAOB audit standards as follows:

- *Unconditional Responsibility:* The words “must,” “shall,” and “is required” indicate unconditional responsibilities. The auditor must fulfill responsibilities of this type in all cases in which the circumstances exist to which the requirement applies.
- *Presumptively Mandatory Responsibility:* The word “should” indicates responsibilities that are presumptively mandatory. The auditor must comply with requirements of this type specified in the Board's standards unless the auditor demonstrates that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard.
- *Responsibility to Consider:* The words “may,” “might,” “could,” and other terms and phrases describe actions and procedures that auditors have a responsibility to consider.

We recognize that in developing the Proposed Standards, the PCAOB has responded to comments received on the original proposed standards that point out the risk that lists of presumptively mandatory requirements would detract from audit quality, create a “check the box” mentality, and impede auditor judgment. The PCAOB eliminated certain presumptively mandatory requirements that were redundant, and some that preceded various lengthy lists of considerations and activities. However, in place of the presumptively mandatory requirements, the present tense has been used, which in some ways is potentially more detrimental to understandability than additional requirements (i.e., it is now not clear whether a requirement is being created or not).

For example, Appendix 4, paragraph 7 requires the auditor to obtain an understanding of the company and its environment. Following that requirement is a statement that: “Obtaining an understanding of the company includes understanding the following:” followed by a list of factors. In the original proposed standards, there was a requirement for the auditor’s understanding to include the factors. We believe that in making this change the PCAOB intended to eliminate the presumptively mandatory requirement; however, the use of the present tense is hard to interpret. In Appendix 9 (page A9-27), the PCAOB discusses the “expansion of requirements” related to obtaining an understanding and states: “The necessary understanding...includes the following.” There is also a footnote indicating similar “provisions” within the Proposed Standards that have been revised. We are not familiar with the concept of “provisions” and their relationship to presumptively mandatory and mandatory requirements. The explanation in Appendix 9 may be read by some to indicate that the requirement in the original proposed standard still exists, albeit worded in the present tense. Others may conclude that because Rule 3101 is not being employed, then the list of factors is provided as guidance and the auditor may use his or her judgment to determine which factors to include in his or her understanding of the company and its environment. In any event, the use of present tense to describe auditor actions results in a lack of clarity about the intended meaning.

We are concerned that writing standards with unclear application of Rule 3101 will significantly affect audit quality and how audit work is assessed by the PCAOB (through its inspection process) and others (e.g., in the litigation context). Using the present tense, including the phrase “needs to be”, creates ambiguity and confusion as to what is required, as it is not clear how such phraseology fits into the Rule 3101 framework, and the auditor procedures to be performed.

4. Documentation requirements

We noted that the conforming amendments of the Proposed Standards included proposed revisions to AS 3 to incorporate specific documentation requirements arising from the requirements of the risk assessment standards. As the PCAOB continues its standard-setting agenda, it would be helpful to understand the PCAOB’s intentions regarding documentation requirements specific to individual standards. In particular, the PCAOB should determine whether it will continually amend AS 3 to add individual documentation requirements as standards are developed or revised, or whether requirements specific to a particular standard will be located in that standard, as is the approach of the IAASB and ASB. We believe it may be confusing to users of the PCAOB’s standards to contend with a continually updated AS 3, and we therefore recommend the PCAOB adopt an approach similar to the IAASB and ASB. We believe setting forth the overarching requirements related to documentation in one place (AS 3) and then reflecting the application of those requirements in the specific context of individual standards would best assist the auditor in meeting the objectives of the individual standards.

5. *The integration of requirements and guidance related to multi-location engagements in the Proposed Standards*

We note that the PCAOB has included certain requirements related to multi-location engagements in the Proposed Standards. On an individual requirement level, we agree with each of the requirements, subject to certain comments in our Specific Comments by Proposed Standard set forth below. However, the PCAOB's 2010 standard-setting agenda as communicated at the October 2009 SAG meeting includes a principal auditor project, which we assume means a revision to, or replacement of, AU 543, *Part of Audit Performed by Other Independent Auditors*. Further, ISA 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*, is effective for periods beginning on or after December 15, 2009. Given all of the current and planned activity related to the execution of multi-location engagements, it is difficult to judge the small number of individual requirements inserted into the Proposed Standards without having the fuller picture of the PCAOB's intentions related to auditing standards for multi-location engagements more generally.

For example, in discussing the multi-location requirements added to Appendix 2, *Audit Planning and Supervision*, Appendix 10 includes a statement that "the provisions in the proposed standard are applicable to all multi-location audits, not just group audits" which we found confusing. We believe that in most circumstances multi-location audit engagements would be considered group audits. It is unclear whether the PCAOB intends to develop a whole standard related to the special considerations related to performing group audits, as has been done by the ASB and IAASB, or whether it intends to include limited requirements in various standards related to multi-location engagements and then revise AU 543 related to the use of the work of another auditor. We believe that the PCAOB should develop a comprehensive standard related to the performance of a group audit holistically (and, if necessary, provide guidance related to its distinction of a group audit from a multi-location audit). We believe the PCAOB should use ISA 600 and the proposed SAS, *Audits of Group Financial Statements (Including the Work of Component Auditors)*, as starting points for the PCAOB's standard.

C. Convergence with other auditing standard-setting bodies

In previous communications with the PCAOB, we have expressed our support for the PCAOB's convergence of its auditing standards with the standards of the IAASB and the ASB. We take this opportunity to again communicate our strong support for convergence.

As we have noted in the past, the Board's consideration of the work by other standard setters is critically important in enhancing the effectiveness and efficiency with which standards are widely understood, implemented, and applied. This is particularly true for multi-location engagements where portions of the work are performed outside the U.S. jurisdiction.

We acknowledge there will be specific areas where the Board believes different requirements are needed for purposes of conducting an audit of a U.S. public company and, as such, we appreciate that the auditing standards of the PCAOB cannot be carbon copies of the ISAs. However, we believe that, in both form and substance, the auditing standards of the PCAOB could converge with the ISAs in many areas. The ISAs are used worldwide as the basis for the majority of public company audits conducted. The standards are developed by a board composed of practitioners and non-practitioners, with key regulators (including the PCAOB) invited to

participate, with speaking rights, at the IAASB's meetings where the ISAs are developed. The ISAs are subject to due process and public consultation as they are developed. In addition, a significant number of auditing firm networks (including the largest networks) use the ISAs as the basis for their global audit policies and methodologies, supplemented as local auditing standards and regulations necessitate.

We believe the PCAOB has the opportunity to effectively and efficiently leverage the work completed by the IAASB and the ASB, and we therefore strongly encourage the PCAOB to use the ISAs as a starting point for the revision of its standards. We do not believe that compelling reasons exist for the PCAOB not to do so.

Converging with the structure of the ISAs and SASs would primarily entail:

- Including an objective in each standard (which we are encouraged to see the PCAOB doing in the Proposed Standards, as we believe objectives are useful in providing context for understanding the requirements of the standard);
- Locating requirements in one section of a standard with a clear identifying heading and using appropriate terminology to establish requirements that are outcome-based auditor actions, followed by sections of guidance that assist the auditor in understanding and implementing the requirements;
- Using the same definitions and terminology as the IAASB and ASB, unless a purposeful change is intended, and in those cases clearly communicating the rationale for such changes and the resulting difference in intended application.

As noted above, we understand that there may be valid reasons for differences between the standards of the PCAOB and the IAASB and ASB standards (i.e., arising from differences in facts and circumstances pertaining to audits of public companies in the U.S). However, for those concepts and requirements that would apply regardless of the jurisdiction or listing status of the company, we believe the PCAOB should converge with the standards of the IAASB and ASB. We believe this is consistent with the PCAOB's view to "eliminate unnecessary differences between the Board's risk assessment standards and other risk assessment standards" as expressed in the release accompanying the original proposed standards. Further, we believe that minimizing differences will help facilitate cross-border cooperation and effectiveness.

We note that the Board did eliminate certain unnecessary differences in the Proposed Standards. However, we believe that the Proposed Standards continue to retain unnecessary differences in form, structure, and content, and we urge the Board to eliminate these remaining differences. We therefore recommend that the PCAOB commit to having differences in its standards only as needed to address issues particular to the audits of public companies in the U.S. In those instances where the PCAOB decides to diverge from the ISAs or ASB standards, the PCAOB should provide a clear and full explanation of the difference, the reason for the difference, and the intended outcome. Providing such information will improve the auditor's understanding of the PCAOB's standards, the auditor's ability to apply the standards, and the transparency of the Board's standard-setting process.

Adoption of an Overall Objectives Standard

One particular overall area of difference between the ISAs and the standards of the PCAOB with which we do not agree, and which we think the PCAOB should address as a high priority, is

the absence of an overall objectives standard in the PCAOB standards, similar to ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing* (“ISA 200”). Appendix 9 did not articulate the PCAOB’s reasons for rejecting this suggestion, which was raised by us and several other commenters³ in relation to the original proposed standards.

Such a standard would:

- Establish the auditor’s overall responsibility when conducting an audit;
- Set out the overall objectives of the auditor;
- Explain the nature and scope of the audit and the inherent limitations of an audit;
- Explain the scope, authority, and structure of the PCAOB standards, including language that denotes requirements;
- Include a discussion of the use of professional judgment;
- Explain how the objectives of each standard relate to the overall framework of PCAOB standards.

While Appendix 1, *Audit Risk* contains some elements of ISA 200, its focus is too narrow, and it excludes certain fundamental principles addressed in ISA 200. We believe it is very important for the Board to explain the fundamental concepts related to the performance of audits and to create guiding principles related to the development of PCAOB standards. Doing so will help clearly communicate the principles of the audit and expectations for auditors. To achieve this, we recommend that the PCAOB immediately commence a project to develop an overall objectives standard, using ISA 200 as a starting point.

D. Standard-setting agenda, timetable, and effective date

Standard-setting agenda and timetable

As noted above, we recognize the initiatives underway by the PCAOB to increase transparency in its standard-setting process. This includes public communication of the PCAOB’s standard-setting agenda for 2010. Based on this agenda, it appears that the volume of activity is expected to increase sharply in the short-term. We are not sure whether the PCAOB has contemplated undertaking revisions to its existing standards as part of a broader project such as the IAASB’s clarity project completed in 2008 or the ASB’s clarity and convergence project expected to be completed later this year. For both these projects, the standard setters undertook a comprehensive activity to revise and redraft their auditing standards within a defined and relatively short time frame. While projects such as these require a significant resource commitment, the improvement in audit quality arising from improved auditing standards is expected to be significant. Completing such a project in a “big bang” approach is useful in that when the standards are revised over a relatively short period, greater internal consistency is achieved and issues of lingering differences in terminology and structure are mitigated. To the extent possible, we recommend that the PCAOB undertake a project to holistically revise and redraft its standards over as short a time period as possible. If the PCAOB agrees to use the ISAs as a starting point (which we highly

³ See, for example, the comment letters submitted by the U.S. Government Accountability Office, the New York State Society of CPAs, Grant Thornton, and the Center for Audit Quality on the originally proposed PCAOB risk assessment standards, in addition to the comment letter we submitted.

recommend), the PCAOB could leverage the work undertaken by the ASB in its clarity and convergence project in which detailed comparisons of the ISAs to the extant SASs (which are similar to the PCAOB's interim standards) were developed.

We understand that there may be complications in undertaking such a project on an aggressive timetable, and that a slower "conversion" period may be necessary. If that is the case, we recommend that the PCAOB consider "bundling" its standards into smaller groups, linked by commonalities within the group. For example, the reporting standards could be worked on as one group. As another example, the principal auditor/group audits standard and the quality control standards could be another group. Because there are significant interactions between standards, to the extent that those standards that are most interlinked can be revised concurrently the better the likely outcome.

Effective date of the Proposed Standards

We found the inclusion of a proposed effective date for the Proposed Standards to be helpful. However, given the PCAOB's active timetable for standard-setting activities in 2010 and beyond, we encourage the PCAOB to revisit the feasibility of the effective date suggested for the Proposed Standards (i.e., years beginning after December 15, 2010). Given the Proposed Standards cover activities early in the audit engagement, the effective date needs to provide time for engagement teams to apply these requirements at the beginning of the audit cycle, rather than after the audit period has begun.

Since the finalization of the PCAOB's standards is dependent on the SEC's approval process, we recommend that as a general rule the effective date for new or revised standards be tied to that process (e.g., standard will be effective 6 – 12 months after the date the SEC approves the new standard). The length of time might be determined based on a consideration of the effect of the standard(s) and the extent of change expected. We believe this approach would be preferable to an approach of selecting what could very well turn out to be an arbitrary date. In addition, providing auditors with a sufficient period of time between the SEC's approval of the standard and its effective date should enable firms to have sufficient time to update their methodologies, training materials, and systems of quality control to reflect the changes. If firms are not given time to adequately deliberate and address changes arising from revised standards and determine their impact on internal guidance and processes, audit quality may likely be diminished and new or revised standards will not likely achieve their intended outcomes.

II. Specific Comments on Proposed Standards by Paragraph

PCAOB Appendix 1 – Audit Risk in an Audit of Financial Statements

The objective of the auditor, as stated in Appendix 1 is “to conduct the audit of the financial statements in a manner that reduces audit risk to an appropriately low level.” While the topics included in this Appendix relate to the overall audit, important concepts, guidance, and principles related to an audit on an overall basis are not included. For instance, a description of reasonable assurance and the inherent limitations of an audit are not included in this Proposed Standard. For these reasons and the reasons articulated in our Overall Comments, we recommend the PCAOB use the material in Appendix 1 and ISA 200 to propose and adopt an overall objectives standard, in lieu of adopting Appendix 1 as proposed.

Paragraph 1: We believe that the wording of paragraph 1 has been revised from the original proposed standard to alleviate concerns raised by commenters that, as originally proposed, the paragraph created the impression that in an integrated audit the auditor performs two separate risk assessments and that the audit of internal control over financial reporting (ICFR) is separate from the audit of the financial statements. However, we still believe that, as written, paragraph 1 and the related footnote implies that there are two separate risk assessments. We believe that there is one risk assessment that is foundational to both aspects of an integrated audit. We believe that paragraph 1 should be amended as follows:

This standard discusses the auditor’s consideration of audit risk and applies to audits of financial statements and integrated audits. When the auditor is performing an integrated audit, the requirements and guidance in Auditing Standard 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*, are also applicable; however, the same risk assessment process forms the foundation for planning and performing procedures designed to support the auditor’s opinion on the financial statements and internal control over financial reporting.

Paragraph 2: We note a terminology difference between the wording of the objective in paragraph 2 and the wording of the objective of ISA 200. In Appendix 1, the level of audit risk is described as “appropriately low,” while in the ISA it is described as “acceptably low.” In line with our Overall Comments about terminology and convergence, it is unclear why the difference exists and whether the PCAOB expects a different threshold to be used by the auditor when evaluating audit risk.

In Appendix 9, the PCAOB indicates the rationale behind the difference in wording from the ISA (“appropriately low” aligns with the language proposed by the PCAOB in the last sentence in paragraph 3, which has been added since the original proposed standard), but does not indicate whether a substantive difference is intended.

We note that PCAOB standards, including the Proposed Standards, use both terms

PCAOB Appendix 1 – Audit Risk in an Audit of Financial Statements

interchangeably when describing the evaluation of risks.

- For example, paragraph 10 of Appendix 1 states: “For a given level of audit risk, the **acceptable level** of detection risk bears an inverse relationship to the risk of material misstatement at the assertion level. The lower the risk of material misstatement, the greater the detection risk that can be accepted. Conversely, the greater the risk of material misstatement, the less the detection risk that can be accepted. As the **acceptable level** of detection risk decreases, the assurance provided from substantive tests should increase.”
- For example, paragraph 9 of AU 330, *The Confirmation Process*, states: “The auditor should assess whether the evidence provided by confirmations reduces audit risk for the related assertions to an **acceptably low level**. In making that assessment, the auditor should consider the materiality of the account balance and his or her inherent and control risk assessments. When the auditor concludes that evidence provided by confirmations alone is not sufficient, additional procedures should be performed. For example, to achieve an **appropriately low level** of audit risk related to the completeness and existence assertions for accounts receivable, an auditor may perform sales cutoff tests in addition to confirming accounts receivable.”

If the terms can be read as synonymous, we believe it would be preferable to use terminology consistent with that in the ISA so as not to cause confusion about whether the PCAOB is creating an intentional difference. If it is the case that the PCAOB is creating an intentional difference, this difference should be fully explained by describing (1) the reason therefore, (2) how the auditor’s performance would be different, and (3) the intended outcome. Further, if a difference is intended, the PCAOB should review its existing standards to determine if conforming changes need to be made to other standards.

Paragraphs 9 and 10: We continue to be concerned about the narrowness of the statement that “the level of detection risk is reduced by performing substantive procedures.” The movement of this sentence from paragraph 10 in the original proposed standard to paragraph 9 in Appendix 1 does not allay our concern.

While we agree with the statement, we believe it may imply that detection risk can **only** be reduced by substantive procedures, and not other procedures such as risk assessment procedures. In Appendix 9, the PCAOB “acknowledges that auditors might obtain evidence of misstatements through procedures other than substantive procedures.” However, this acknowledgement is not reflected in the discussion in paragraphs 9 and 10. To avoid unnecessary confusion, we recommend that the second sentence of paragraph 9 be deleted. We also recommend that the last sentence in paragraph 9 and the last sentence in paragraph 10 be broadened to refer to “audit procedures” as opposed to “substantive procedures” or “substantive tests,” respectively.

PCAOB Appendix 2 – Audit Planning and Supervision

We believe that the concepts of planning the audit and supervision have been integrated into a single Proposed Standard because these concepts are combined in the PCAOB’s existing standards. While we acknowledge that selecting the engagement team is part of the audit planning process, supervising the team occurs throughout the audit. We believe the concepts of audit planning and supervision are separate and distinct, and we therefore believe that they warrant individual attention in two different standards, as they have been treated in the ISAs.

Paragraph 3: As noted in our Overall Comments regarding terminology above, the use of “auditor” and “engagement partner” seem inconsistent. As a further example, paragraph 3 specifies the responsibilities of the “engagement partner” and refers to the definition provided in the Appendix to the Proposed Standard. Paragraph 4 requires the “auditor” to properly plan the audit. It is unclear whether the auditor referred to in paragraph 4 means the engagement partner. We recommend that the PCAOB revisit its use of the terms “auditor” and “engagement partner,” particularly in requirements, to clarify to whom the requirements are directed.

Paragraph 6: The Note to paragraph 6 has been modified from the original proposed standard. In the original standard, the wording of the note was factual:

Note: The decision regarding continuance of the client relationship and determination of compliance are not limited to preliminary engagement activities and could change with changes in circumstances.

In the Proposed Standard, the wording has been revised to contain an auditor requirement to re-evaluate the decisions regarding continuance and compliance with “changes in circumstances.” However, no additional guidance has been provided regarding the nature of “changes in circumstances” where it would be appropriate for the auditor to re-evaluate these decisions.

We did not see an explanation for the change in Appendix 9 so it is not clear what prompted the PCAOB to convert the note into a requirement. We believe the concept of awareness of continuance and compliance issues being a continuing process throughout the audit is more clearly expressed as written in the original proposed standard (i.e., not stated as a requirement) and therefore recommend the PCAOB use that language. If the PCAOB retains the auditor requirement, in line with our comments on the structure of the standards above, we recommend that requirement be included in the main text of the paragraph rather than in a note and that the PCAOB clarify the rationale for the requirement and its intended meaning.

Paragraph 10b: Proposed Auditing Standard *The Auditor’s Responses to the Risks of Material Misstatement* and AS 5 both include requirements to consider an assertion-level audit response. However, paragraph 10b does not specify that the audit plan should include planned tests at the relevant assertion level. In order to be consistent, we recommend

PCAOB Appendix 2 – Audit Planning and Supervision

paragraph 10b be revised to read “...the planned nature, timing and extent of tests of controls and substantive procedures at the relevant assertion level.”

Paragraphs 11-14: We refer you to our Overall Comment on the integration of requirements and guidance related to Multi-location Engagements into the Proposed Standards.

Paragraphs 16-18: As noted above, we believe that the requirements related to supervision should be included in a separate standard rather than being coupled with requirements related to audit planning. Whether the PCAOB decides to implement that recommendation or retain the paragraphs in a combined standard, we recommend that the structure of paragraphs 16 – 18 be revised, as we found the paragraphs to be confusing and their content to be somewhat redundant.

The Note in paragraph 16 defines “specialized skill or knowledge” as “persons engaged or employed by the auditor who have specialized skill or knowledge.”

The first sentence of paragraph 17 then reads: “If a person with specialized skill or knowledge *employed or engaged by the auditor* participates in the audit...” We believe that the italicized language is unnecessary and potentially confusing, since the Note in paragraph 16 has already defined “specialized skill or knowledge” as referring to persons engaged or employed by the auditor.

We further believe that paragraph 18 and the Note to paragraph 16 are redundant of each other, with paragraph 18 just providing slightly more detailed content. We suggest that the Note to paragraph 16 be deleted.

In addition, we recommend that “apply” in paragraph 16 be replaced with “plan and perform” as the auditor should consider whether specialized skill was needed in planning the procedures as well as executing them.

Paragraph 17: As currently stated, the third bullet of paragraph 17 indicates that the auditor should have sufficient knowledge to enable the auditor to evaluate the results of the procedures performed by the person (with specialized skill or knowledge) “as they relate to the nature, timing and extent of other planned audit procedures and the effects on the auditor’s report.” We believe the desired outcome of the auditor’s evaluation would be more clearly stated as follows:

Evaluate the adequacy of that person’s work including the relevance and reasonableness of that person’s findings or conclusions and their consistency with other audit evidence.

We believe this more clearly articulates the nature and purpose of the auditor’s evaluation of the work of the person with specialized skill or knowledge; namely the auditor would want to evaluate the findings as audit evidence and how that audit evidence “fits” with the other audit

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evidence. We note that our suggested language is consistent with language in ISA 220, paragraph A20.

PCAOB Appendix 3 – Consideration of Materiality in Planning and Performing an Audit

Paragraph 2: Appendix 9 provides the PCAOB’s rationale for modifying the discussion of the concept of materiality in terms of the Supreme Court’s interpretations of federal securities laws rather than in terms of the applicable accounting framework. As a result of this change, the Proposed Standard uses the perspective of a “reasonable investor” in evaluating materiality rather than a “reasonable person relying on the report.” It is not clear whether narrowing the perspective to investors, rather than other persons who may rely on the report, is expected to affect the auditor’s determination, or evaluation, of materiality. The PCAOB should communicate whether the change was intended solely to align the PCAOB standards with existing interpretations of federal securities laws or whether a substantive change in practice is expected.

Paragraph 3: As noted in our Overall Comments, we believe that a standard which includes the foundational concepts related to an audit, including a discussion about reasonable assurance and its meaning, should be developed and incorporated into the PCAOB’s auditing standards. Having such a standard would facilitate an understanding of reasonable assurance in the context of its placement in paragraph 3 of the Proposed Standard. In addition, we note that paragraph 3 appears to be based on excerpted elements of paragraphs 6 and A1 of ISA 320, *Materiality in Planning and Performing an Audit* (“ISA 320”). We believe that the concepts described in paragraph 3 would be clearer and easier for auditors to apply if the language of the paragraph more closely mirrored that of paragraph 6 of ISA 320, which contains a more complete discussion:

In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:

1. Determining the nature, timing and extent of risk assessment procedures;
2. Identifying and assessing the risks of material misstatement; and
3. Determining the nature, timing and extent of further audit procedures.

The materiality determined when planning the audit does not necessarily establish an amount below which uncorrected misstatements, individually or in the aggregate, will always be evaluated as immaterial. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below materiality. Although it is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature, the auditor considers not only the size

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but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements.

Paragraphs 8 and 9: The paragraphs use the term “tolerable misstatement” to explain what we believe is the concept of “performance materiality” as used in the related ISA (see ISA 320, paragraph 11) and revised SAS (see revised AU 312, *Materiality in Planning and Performing an Audit*, paragraph 11). Using the term “tolerable misstatement” to describe what is defined as “performance materiality” in the ISAs will cause confusion. Appendix 9 indicates that the PCAOB believes use of “tolerable misstatement” will be less confusing than using “performance materiality” because it is the term currently used, and because non-auditors may be confused because “performance materiality” contains the word “materiality.” On the first point, we believe that adoption of “performance materiality” will relieve existing confusion in practice, rather than create it, for the reasons stated below.

The term “tolerable misstatement” in the ISAs is the *application* of performance materiality to a particular sampling procedure, and may be the same amount or an amount lower than performance materiality. “Performance materiality,” however, is the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an acceptably low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.

As part of its clarity project to revise ISA 320, the IAASB addressed the confusion that existed in practice at that time about the dual use of the term (as both the amount set at less than materiality for the financial statements as a whole and the application of that amount to a sampling procedure) by using two terms: performance materiality and tolerable misstatement.

We believe the PCAOB should adopt the same approach as the IAASB in order to mitigate the existing confusion in practice and to prevent future confusion about the difference in terminology between the standards of the IAASB and ASB and the standards of the PCAOB. If the PCAOB chooses to retain the term “tolerable misstatement” to cover both concepts, Appendix 10 comparing the PCAOB’s standards with the ISAs and SASs will have to point out that “tolerable misstatement” in the PCAOB standards can mean either “tolerable misstatement” or “performance materiality” in the ISAs.

On the second point about the potential confusion of non-auditors, we believe the use of the term “performance materiality” (particularly given its use of the related word “materiality”) would actually assist the non-auditor in understanding the relationship between materiality for the financial statements as a whole and the implementation of that concept in planning and performing the audit.

Paragraph 10: We refer you to our Overall Comments on the integration of requirements and guidance related to Multi-location Engagements into the suite of re-proposed Risk Assessment standards.

PCAOB Appendix 3 – Consideration of Materiality in Planning and Performing an Audit

In addition to our Overall Comments, we believe that the requirement in paragraph 10 does not contemplate a situation where the principal auditor refers to the work of another auditor in the audit report on the group financial statements in accordance with AU 543, *Part of Audit Performed by Other Independent Auditors*. In such situations, the principal auditor may not influence, or even be aware of, the materiality level used by the auditor to whom the principal auditor will refer. It is unclear what the principal auditor should do in those situations in addressing the requirement in paragraph 10.

Paragraph 11: The auditor action required by the paragraph (“the auditor should reassess” the materiality level) is different than the analogous paragraph in ISA 320 (“the auditor shall revise materiality”). The wording of paragraph 11 (i.e., to reassess materiality when there is “substantial likelihood that misstatements of amounts that differ significantly from the materiality level or levels that were established initially would influence the judgment of a reasonable investor”) is also rather convoluted and may be more difficult to understand than a more directly worded requirement to revise materiality when subsequent events or information are such that the auditor would have determined a different materiality had the auditor known about them. We are not sure if the PCAOB intends a difference in auditor performance by using different wording in the requirement. If a difference is not intended, we recommend that ISA 320, paragraph 12 (included below), which we believe contains a clearer and more strongly worded requirement, replace paragraph 11 in the Proposed Standard:

The auditor [should] revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially.

In addition, as currently drafted, there does not seem to be a clear difference between the situations described in paragraphs 11a and 11b. Both refer to situations where the amounts used to determine the materiality level or levels have changed, and neither explicitly addresses the point in the audit when the auditor may determine a revision in materiality is warranted.

Appendix 9 (page 9-21) includes two detailed examples of situations which may be useful to include in the Proposed Standard. Alternatively, the language in paragraph A13 of ISA 320, which we believe more clearly articulates the concepts related to the revision of materiality as the audit progresses, could be used.

PCAOB Appendix 4 – Identifying and Assessing Risks of Material Misstatement

Paragraphs 1, 3, and A4: We note that the objective in paragraph 3 has been revised based on comments received by the PCAOB. It now provides a stronger link between identifying and assessing risks and responding to those risks. We believe the change clarifies the relationship between risk assessments and responses. In addition, the change has resulted in the objective of the Proposed Standard becoming closer to the wording of the objective in ISA 315.

In the same vein, we believe that an additional change to the objective would be useful to clarify *how* the auditor goes about identifying and assessing risks (i.e., based on the auditor’s understanding of the company and its environment, including its internal control). We recommend the objective be worded as follows, which would align it with the ISA 315 wording exactly. Appendix 10 did not include the difference in the objective between the two standards, so we presume that no fundamental change in the objective is intended by the PCAOB; therefore, using the ISA 315 wording would seem to be appropriate and would avoid unnecessary confusion:

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 [company’s] internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

For the same reasons described above (i.e., to make the language in the standard clearer about how the auditor identifies and assesses risks), which we believe will increase the auditor’s understanding about how to implement the required auditor action, we recommend the following changes to paragraphs 1 and A4:

Paragraph 1: We believe it would be helpful to add “through understanding the company and its environment, including the company’s internal control” at the end of the paragraph.

Paragraph A4: We believe it would be helpful to add “whether due to fraud or error, at the financial statement and assertion levels” to the end of the definition.

Paragraphs 7-13: As noted in our Overall Comments, we are concerned about the use of present tense in the Proposed Standards, because it is unclear whether the PCAOB intends for “provisions” written in present tense to be considered requirements. Paragraphs 7 – 13 provide a cluster of examples of the lack of clarity caused by the use of present tense. For example:

- Paragraph 7 has a requirement for the auditor to obtain an understanding of the company and its environment. That requirement is followed by a statement that “obtaining an understanding of the company includes understanding the following:”
- Paragraph 10 indicates that “obtaining an understanding of the nature of the

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company includes understanding the following:”

- Paragraph 12 states that "The following matters, if present, are relevant to the necessary understanding..."

Based on our understanding of Rule 3101, we do not believe that present tense statements obligate the auditor to perform the activity described by the present tense. We believe in the paragraphs cited above, the lists following the paragraphs may not be relevant in all situations and therefore it would not be appropriate to require the auditor to pursue each item on the list. Accordingly, it would be appropriate for the auditor to use the lists as guidance in applying the requirements that are identified in accordance with Rule 3101.

Paragraph 10: The first Note in paragraph 10 indicates that “the size and complexity of a company might affect the risks of misstatement and how the company addresses those risks.” We believe all of the bullets in paragraph 10 may affect the risks of misstatement, and the company’s responses thereto (e.g., the sources of funding of the company’s operations, the company’s organizational structure). It is unclear why size and complexity are singled out for emphasis, and we therefore recommend that the Note in paragraph 10 be deleted.

As noted in our Overall Comments, the purpose and use of Notes by the PCAOB is unclear. As a result, we believe that requirements should not be placed in Notes. The second Note in paragraph 10 includes a requirement for the auditor to “take into account” the information gathered when obtaining an understanding of the company in order to determine the existence of related parties. The action to “take into account” is sufficiently unclear in this context as to make it difficult for the auditor to demonstrate and document compliance with the requirement. Furthermore, we believe the principle embodied in the Note is factual (as it is structured in paragraph A23 of ISA 315) and should be stated as such in the Proposed Standard in place of the requirement:

An understanding of the nature of a [company] enables the auditor to understand such matters as: The ownership and relations between owners and other people or [companies]. This understanding assists in determining whether related party transactions have been identified and accounted for appropriately.

Paragraph 11: We believe that the second bullet in paragraph 11 is extremely broad, and that a requirement for the auditor to consider “observing or reading transcripts of earning calls and, to the extent publicly available, other meetings with investors or rating agencies” will be onerous and likely ineffective.

Obligating the auditor to determine the existence and timing of all “other meetings with investors” in order to consider attending them and to document why or why not the auditor attended such meetings would likely be very onerous and would result in additional costs without an equal benefit. We therefore recommend that this bullet be deleted from the list in paragraph 11.

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Paragraphs 20 and 62 - 65: Paragraphs 64-65 imply that walkthroughs would be sufficient for evaluating whether a control has been implemented. The first Note in paragraph 20 states that a walkthrough is ordinarily sufficient to evaluate design effectiveness, but neither the first nor second note make it clear that a walkthrough is ordinarily sufficient to evaluate implementation. In order to be consistent with paragraphs 64 – 65 and to clarify paragraph 20, we recommend such a statement be added to the second Note to paragraph 20.

Paragraph 24: The wording of this paragraph provides an additional example of our Overall Comments related to the use of present tense, and the confusion it causes as to whether the PCAOB intends a required auditor action. We note that in the original proposed standard the paragraph was worded as a requirement (“should assess”). We believe paragraphs 23 and 24 would be more understandable to the auditor if they were combined, with the header to the bullet list reading as follows:

The auditor should obtain an understanding of the company’s control environment, including the policies and actions of management, the board and the audit committee concerning the company’s environment, including:

Paragraph 39: We are concerned about the language of the requirement for the auditor to “*incorporate* knowledge obtained during past audits into the auditor’s process for identifying risks of material misstatement...” This is not an actionable instruction as it is not clear what “incorporate” means or how the auditor would demonstrate compliance with this requirement. Further, it is not clear whether the requirement would be met if the auditor determined not to use prior-year work, for example, because changes to the control environment have affected the relevance of the information. We believe the wording of the analogous paragraph in ISA 315, paragraph 9 is clearer, and recommend that it replace paragraph 39:

When the auditor intends to use information obtained from the auditor’s previous experience with the [company] and from audit procedures performed in previous audits, the auditor shall determine whether changes have occurred since the previous audit that may affect its relevance to the current audit.

Paragraph 42: As noted in our Overall Comments, there seems to be some confusion about the use of, and relationship between, “auditor” and “engagement partner” in the Proposed Standards. It is unclear from paragraph 42, whether “auditor” refers to the engagement partner, the registered public accounting firm, or a network of related firms if one exists. The more broadly the term is incorporated into a requirement such as this one, the more of a practical challenge it will likely pose, and therefore care needs to be taken such that the incremental effort is really intended and appropriate. Similarly, without any guidance, the interpretation of “other information” could be quite broad. In a multi-location, multi-national audit engagement, the gathering of that “other information” from all individual auditors

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participating on other engagements for the purposes of the group audit would likely consume significant resources and drive costs that would not seem to achieve commensurate benefit. We recommend that the language of ISA 315, paragraph 8 be used in place of paragraph 42, as we believe it more clearly reflects an appropriate auditor action:

If the engagement partner has performed other engagements for the [company], the engagement partner [should] consider whether information obtained is relevant to identifying risks of material misstatement.

Paragraphs 43 and 45: The note in paragraph 45 indicates that analytical procedures performed as risk assessment procedures are “ordinarily not designed with the level of precision necessary for substantive analytical procedures.” However, the language in paragraphs 43 and 45 seems to be describing substantive analytical procedures as opposed to preliminary analytical procedures. Paragraph 45 discusses developing expectations and comparing those expectations with recorded amounts, which implies an extent of procedures more common to substantive analytical procedures and apparently different from the PCAOB’s existing guidance on preliminary analytical procedures, included in paragraphs 6 – 8 of AU 329, *Analytical Procedures*. It is unclear whether the PCAOB intends a change in practice regarding the execution of analytical procedures performed as risk assessment procedures.

Paragraph 67: This paragraph states that “the auditor should not assume that all of the conditions discussed in paragraph 66 must be observed or evident to conclude that a fraud risk exists.” It is not clear what action the auditor would need to take to “not assume” and then how the auditor would document that negative assumption.

Paragraph B6: The requirement in this paragraph to “design procedures to test the consistency in the application of manual controls” when a company uses manual elements in internal control systems is misleading and out of context. It may imply that for any manual controls, the auditor is required to perform testing. We believe the paragraph should read:

When a company uses manual elements in internal control systems and the auditor is planning to rely on, and will therefore test, those manual controls, the auditor should design procedures to test the consistency in the application of manual controls.

PCAOB Appendix 5 – The Auditor's Response to the Risks of Material Misstatement

Paragraphs 1 and 2: In the objective of Appendix 4, *Identifying and Assessing Risks of Material Misstatement*, we note that the PCAOB has improved the linkage between identifying and assessing risks of material misstatement, and then implementing responses to those risks, by adding language to the objective since the original proposed standard. To be consistent, we recommend the PCAOB similarly strengthen the linkage in the objective of this Proposed Standard to the identified risks. We believe the objective should read as follows:

The objective of the auditor is to address the identified risks of material misstatement through appropriate overall audit responses and audit procedures.

In Appendix 9, the PCAOB indicates that it received similar comments on the objective in the original proposed standard. We also note the PCAOB has included a mandatory requirement in paragraph 3 of the revised Proposed Standard to design and implement responses that address the risks identified and assessed in the Proposed Standard, *Identifying and Assessing Risks of Material Misstatement*, as a means of making the linkage outside of the objective. However, we continue to believe that the objective would be more appropriate worded as we suggest above.

Further, for the reasons stated above and to have consistency between paragraphs 1 and 2, we believe paragraph 1 should read as follows:

This standard establishes requirements and provides direction regarding designing and implementing appropriate responses to the identified risks of material misstatement.

Paragraphs 11 and 13: These paragraphs create presumptively mandatory requirements to perform substantive procedures, including tests of details, in response to assessed significant risks and assessed fraud risks, respectively. Appendix 9 states that “existing PCAOB standards indicate that tests of details should be performed in response to significant risks” and it references AU 329, paragraph 9. That paragraph states:

The auditor’s reliance on substantive tests to achieve an audit objective related to a particular assertion may be derived from tests of details, from analytical procedures, or from a combination of both. The decision about which procedure or procedures to use to achieve a particular audit objective is based on the auditor’s judgment on the expected effectiveness and efficiency of the available procedures. For significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.

We do not believe, as written, that paragraph 9 of AU 329 and the proposed language in paragraphs 11 and 13 are equivalent. Our interpretation of the last sentence of AU 329 paragraph 9 is that it would be acceptable for an auditor to perform tests of relevant controls in combination with substantive analytical procedures to address a significant risk (including a fraud risk), i.e., in such a case the auditor’s evidence is not being derived from substantive analytical procedures alone. Our interpretation of paragraphs 11 and 13 is that this approach would no longer be acceptable and that substantive tests of details would now be required in addition to, or in place of, substantive analytical procedures. This would be a significant change in practice and one that

PCAOB Appendix 5 – The Auditor's Response to the Risks of Material Misstatement

we believe will likely increase cost without necessarily resulting in a more effective audit. We continue to believe that the auditor, based on judgment, the risks identified, and the facts and circumstances of the situation, should be able to decide whether to perform substantive analytical procedures or test of details in response to any identified risk and should not be limited to the types of procedures to perform. We do, however, continue to believe that evidence from substantive analytical procedures alone (i.e., without also performing tests of relevant controls) is unlikely to be sufficient and appropriate in addressing significant risks of misstatement.

Paragraph 29: Paragraph 29 requires the auditor when testing operating effectiveness as of or through an interim date to “determine what additional evidence concerning the operation of the controls for the remaining period is necessary” but it does not require the auditor to also “obtain audit evidence about significant changes to those controls subsequent to the interim period” as ISA 330 paragraph 12 does. We are concerned that the PCAOB requirement could be perceived as weaker than the ISA, and therefore recommend that bullet (b) of ISA 330, paragraph 12 be added to paragraph 29.

Paragraph 31: The paragraph does not provide the perspective that over time as the audit evidence ages, the less relevant it will become. We believe that paragraphs 13 and 14 of ISA 330 provide useful considerations about the relevance of audit evidence (1) over the passage of time and (2) over the period of time that elapses between testing of a control and retesting the control. We recommend that the PCAOB consider incorporating these paragraphs into the Proposed Standard, particularly the requirement in paragraph 14 to test controls at least once every third audit if no significant changes in controls have occurred.

PCAOB Appendix 6 – Evaluating Audit Results

Paragraph A2: We believe the definition of “misstatement” is unclear because (1) it includes the term “misstatement” within the definition and (2) appears to be defining a misstatement as being only a material misstatement (i.e., an immaterial error would not be considered a misstatement).

As noted in our Overall Comments related to terminology, as well as convergence, we feel this is one area where a difference with the ISA definition of “misstatement” is unwarranted, and may cause unnecessary confusion. We do not believe the PCAOB intends for there to be a difference in meaning.

In Appendix 9, the PCAOB references guidance in AU 312, *Audit Risk and Materiality in Conducting an Audit* and AU 9312, *Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312* as rationale for retaining the proposed language. While we recognize the PCAOB may have an aversion to changing terminology related to misstatements,

PCAOB Appendix 6 – Evaluating Audit Results

we also note that it has not chosen to carry forward the terminology “known” and “likely” misstatements, which is also currently used in AU 312.

We therefore suggest that the PCAOB use the definition of “misstatement” in ISA 450, *Evaluation of Misstatements Identified During the Audit*:

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 items to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

Paragraph 12: The types of misstatements that the auditor accumulates are detailed in paragraph 12 of the Proposed Standard, but it does not use the same categorization, or “buckets” as are used by the ISAs: factual misstatements, judgmental misstatements, and projected misstatements. Nor does it use the same categorization as AU 312, as noted above. We believe being able to clearly distinguish the types of misstatements assists the auditor in accumulating and evaluating them. Such categorization also makes it easier for management and audit committees to understand misstatements and also to correct them. It is unclear why such helpful guidance would not be included in the PCAOB’s standard.

Paragraph 15: In the Proposed Standard, the auditor is required to communicate accumulated misstatements to management, but there is no requirement for the auditor to request management to correct misstatements. This differs from the PCAOB’s existing requirement in AU 312 for the auditor to request management to “eliminate” likely misstatements that, individually or in the aggregate, cause the financial statements to be materially misstated.

We believe that an auditor requirement to request management to correct all misstatements accumulated during the audit, other than those that are clearly trivial, is appropriate. Appendix 9 indicates that such a requirement is unnecessary because “management has its own legal responsibilities in relation to the preparation and maintenance of the company’s books, records, and financial statements.” However, a requirement in the Proposed Standard would be for the auditor, not management, and would provide an important link between the auditor requesting management to correct and management’s subsequent actions in that regard. Management’s failure to correct misstatements that the auditor has requested be corrected may also be relevant information to the auditor and the auditor’s risk assessment.

Paragraphs 18: We recommend that additional context be provided to paragraph 18 by including a reference to SEC Staff Accounting Bulletin 108, codified as SAB Topic 1.N, “Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements.” We believe this will be especially useful for auditors outside the U.S. jurisdiction who are applying the standards of the PCAOB.

PCAOB Appendix 6 – Evaluating Audit Results

Paragraph 20: The second sentence of the paragraph contains an excerpt of paragraph .05 of AU 316 defining “fraud.” However, in not including the paragraph in its entirety, the paragraph does not convey the full context of paragraph .05. In addition, while fraud risk is discussed earlier in the Proposed Standard (paragraph 4d) and the term “fraud” is used earlier in the Proposed Standard, it is unclear why the second sentence is placed in paragraph 20 of the Proposed Standard rather than in an earlier paragraph.

Paragraph 27: The second sentence of the paragraph discusses management bias, but only in a “one-way” direction (i.e., increases in income). We believe it would be relevant to discuss both directions of potential bias (i.e., as efforts to improve or worsen reported results). Alternatively, if the second sentence is meant to be an example, it should be labeled as such.

Paragraph 31: The second sentence of paragraph 31 causes us two concerns:

1. It is written in the present tense, and given its placement is difficult to determine whether the PCAOB believes it is a requirement
2. The level of detail provided for consideration in evaluating disclosures (e.g., form, arrangement, content, terminology, and classification) may be difficult to implement and assess, given the relevant authoritative accounting framework and related literature may not be that detailed.

We agree with the addition of guidance related to evaluating disclosures, but recommend that the PCAOB clarify that the auditor’s evaluation of disclosures is performed within the context of the requirements of the applicable accounting framework.

Paragraph 35: We believe the use of “substantial doubt” in the context of evaluating audit results may be confusing in light of its more frequent use in the context of the going concern evaluation. As noted in our Overall Comments related to terminology, this is an example where a review of terms used in the Proposed Standards could assist in “cleaning up” terminology. While we recognize the term is used in AU 326, *Evidential Matter*, we recommend that the PCAOB eliminate the phrase in the Proposed Standard which includes “substantial doubt” as we believe the point of the paragraph is covered sufficiently within the context of sufficient appropriate audit evidence. Therefore, we recommend that the first sentence of paragraph 35 read as follows:

If the auditor has not obtained sufficient appropriate audit evidence about a relevant assertion, the auditor should attempt to obtain further audit evidence to address the matter.

PCAOB Appendix 7 – Audit Evidence

Paragraphs 3 - 4: We are unsure why there is a difference between the language used in the objective (i.e., “plan and perform”) and the requirement in paragraph 4 (i.e., “design and perform”). We believe the language used should be consistent between the two paragraphs.

Paragraph 11: We strongly recommend that the PCAOB consider using the assertions as described in the ISAs, as well as in the ASB’s standards. The assertions used by these standard setters do not differ greatly overall from the assertions included in the Proposed Standards. However, on an individual basis, the assertions are more granular and we believe will be more helpful to auditors in both assessing risks of misstatement and planning and performing procedures to address those risks. For example, the ISA assertions about presentation and disclosure include classification and understandability: that financial information is appropriately presented and described and disclosures are clearly expressed. We believe that this level of detail would be very helpful in improving audit quality and in addressing certain shortcomings noted in the PCAOB’s *Report on First-Year Implementation of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (September 24, 2009).

Paragraph 18: Appendix 9 does not explain why paragraph 18 was changed to eliminate the guidance about written confirmations. The phrase, “written confirmations might be received in paper form, or by electronic or other medium” implied an expectation that confirmations would be in writing. We believe confirmations should be obtained by the auditor as a direct written response to the auditor from a third party, and therefore suggest the reinstatement of this guidance, or something similar in the Proposed Standards.

PCAOB Appendix 8 – Conforming Amendments

General Comment: While we agree with replacing “competent” with “appropriate” throughout the standards, this change results in the phrase “sufficient appropriate evidential matter.” The entire phrase therefore needs to be replaced with “sufficient appropriate audit evidence” to be consistent with the title of Appendix 7 and language used in the Proposed Standards.

AU 322: Based on the proposed Conforming Amendments, footnote 3 to paragraph 4 contains a reference to Proposed Standard, *Identifying and Assessing Risks of Material Misstatement* (Appendix 4); and states that the Proposed Standard “indicates that the internal audit function is part of the entity’s control environment.” However, there is no discussion of internal audit as being part of the entity’s control environment in paragraphs 23 – 25 of Appendix 4; rather,

internal audit is discussed in the context of monitoring in paragraph 34 of this Proposed Standard. We suggest the footnote be modified accordingly.

Additionally, the proposed Conforming Amendments for AU 322 include a reference to paragraph 42 of Proposed Standard, *The Auditor's Responses to the Risks of Material Misstatements*, in Footnote 5. We do not understand why the footnote reference is to paragraph 42, which discusses the extent of substantive procedures.

AU 329: While paragraph .03 was deleted (see text below), this paragraph still appears to be relevant to substantive analytical reviews; therefore, we recommend retaining this paragraph.

Understanding financial relationships is essential in planning and evaluating the results of analytical procedures, and generally requires knowledge of the client and the industry or industries in which the client operates. An understanding of the purposes of analytical procedures and the limitations of those procedures is also important. Accordingly, the identification of the relationships and types of data used, as well as conclusions reached when recorded amounts are compared to expectations, requires judgment by the auditor.

AU 350: In paragraph .09 of AU 350, we recommend the reference should be to paragraphs 3 through 10 of Proposed Standard, *Audit Risk*, as opposed to paragraphs 5 through 10.

ET 102: The reference in footnote 1 to paragraph .05 has been revised to refer to the Proposed Standard, *Audit Planning and Supervision*. However, the discussion regarding disagreements was removed from the Proposed Standard and has now been proposed as a conforming amendment to AS 3. If the conforming amendment is made to AS 3, this reference should be changed accordingly.