

March 2, 2010

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

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

Dear Sir:

We appreciate the opportunity to respond to the Public Company Accounting Oversight Board's (PCAOB or the "Board") *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards* (the "standards," "proposed standards" or "proposals").

We fully support the Board's objective to update its interim standards regarding risk assessment. Identifying, assessing and responding to risks are integral to the audit process and fundamental to the conduct of high quality, effective and efficient audits. We believe that the proposed standards are significantly improved. For example, appropriate linkage between assessed risk and auditor's response has been added; alignment with Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AS 5) has been improved; enhancements were made in the consistency of the usage of terminology; and overall organization is generally enhanced. We appreciate the Board's responsiveness in considering, addressing and providing feedback on comments received on the original proposal.

We also commend the Board for reexposing these proposed standards, particularly given that these standards provide the foundation for all audits and, additionally, will provide a basis for the Board's future standard setting activity.

While appreciative of the improvements from the original draft, we have concerns about certain provisions in the reexposed proposals. In the remainder of our letter, we have organized our overall observations and concerns about the proposal into the following topical areas:

- Increased integration with AS 5
- Overarching observations and recommendations on the standard setting process
- Effective date

Finally, we have included our specific comments for each of the proposed standards and the conforming amendments in the Appendix to this letter.

Increased Integration with AS 5

We believe that the Board has made significant improvements with respect to aligning guidance in the proposed standards with that in AS 5. In particular, we believe that the Board has appropriately eliminated from the proposals certain guidance that is relevant only to an integrated audit. In addition, we agree with the incorporation of additional guidance from AS 5 on multilocation engagements (in paragraphs 11-13 of proposed standard *Audit Planning and Supervision*) and identifying significant accounts and disclosures and their relevant assertions (in paragraphs 57-61 of proposed standard *Identifying and Assessing Risks of Material Misstatement*).

We have some concern, however, about the manner in which some guidance from AS 5 has been incorporated into the proposed standards, as further described below.

Identifying and Assessing Risks of Material Misstatement

At paragraphs 62-65 of the proposed standard, the Board has included a new subsection, "Understanding Likely Sources of Misstatement," from paragraphs 34-38 (omitting paragraph 35) of AS 5. Paragraph 62 requires the auditor to achieve various objectives to further understand the likely sources of potential misstatements, including a requirement to identify the controls management has implemented to address potential misstatements. Moreover, paragraph 64 describes walkthroughs as frequently being the most effective way of achieving the objectives of paragraph 62. Walkthroughs are described as consisting of following transactions from origination to a company's financial records, usually using a combination of inquiry (including probing questions), observation, inspection of relevant documentation, and reperformance of controls.

In AS 5, the required understanding is used to inform the auditor's selection of the controls to test and also constitutes procedures that result in obtaining evidence regarding the effectiveness of controls. In a financial statement audit only (i.e., one that is not integrated with an audit of internal control over financial reporting), however, the auditor may elect to use a substantive approach and therefore decide not to rely on certain controls. In such circumstances, we are concerned that aspects of the requirements in paragraphs 62 and 64-65 may be interpreted as requiring the testing of controls for effectiveness even when the auditor does not plan to rely on such controls. Such extension of auditor responsibility would add unnecessary cost without a corresponding increase in audit quality. We believe the Board should either delete paragraph 62 or make it applicable only in relation to controls the auditor plans to test.

If the Board decides to retain paragraph 62, we believe the Board should consider how the first objective, which is to "Understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorized, processed, and recorded," is distinguished from the objective of paragraph 28 subparagraphs (a) and (b) which require the auditor to obtain an understanding of "the classes of transactions in the company's operations that are significant to the financial statements" and "the procedures, within both automated and manual systems, by which those transactions are initiated, authorized, processed, recorded, and reported." We believe that it may be confusing to retain paragraph 62 in its current form rather than integrate it with the requirements in paragraph 28.

We believe that the Board should retain paragraph 63, which requires the auditor to understand how information technology affects the company's flow of transactions, even if paragraph 62 is removed. We recommend, however, moving paragraph 63 to follow paragraph 28 of the proposed standard. We also recommend moving the presumptively mandatory requirements out of Appendix B and into paragraph 63 as we continue to believe that placing presumptively mandatory requirements in the text of the standard heightens their visibility.

Lastly, we recommend the Board consider moving the guidance in paragraphs 64-65 on performing walkthroughs to follow paragraph 20, and making the following changes: (1) changing the first sentence of paragraph 64 to state that walkthroughs may be performed in connection with obtaining an understanding of internal control, (2) stating that walkthroughs ordinarily are sufficient to evaluate design effectiveness and to establish that controls have been implemented, and (3) deleting the references to walkthroughs in the Notes in paragraphs 19 and 20.

The Auditor's Responses to the Risks of Material Misstatement

The Board has revised paragraph 31 of this proposed standard to incorporate from AS 5 additional factors that the auditor should take into account in determining the evidence needed during the current year audit to support the auditor's control risk assessments. The second sentence of this paragraph establishes a presumptively mandatory requirement for the auditor to take these fifteen factors into account when controls have been tested in past audits. We believe this requirement should apply *only* when the auditor intends to use evidence obtained from tests of controls in prior year audits in the current year audit. Finally, we recommend that the Board revise paragraph 31 to incorporate the guidance from paragraphs 57 and 59 of AS5 which allows the auditor's experience in prior years to inform its assessment of risk, which in turn affects the nature, timing, and extent of testing necessary.

Overarching Observations and Recommendations on the Standard Setting Process

Convergence of Auditing Standards

As discussed more fully in our February 18, 2009 comment letter on the original proposal, we continue to support the Board's consideration of the work of other standard setters, including the International Auditing and Assurance Standards Board (IAASB) and the AICPA's Auditing Standards Board (ASB). We continue to believe that increased convergence of high-quality auditing standards has the potential to elevate the consistency of the quality of audits performed worldwide, including those performed in accordance with the PCAOB's standards. Accordingly, we continue to encourage the Board to avoid creating unnecessary differences between its standards and the International Standards on Auditing (ISAs), introducing differences only when necessary for audits, including integrated audits, of issuers.

Although significant differences remain, we recognize that the proposed standards are more closely aligned with the IAASB's ISAs than the prior proposal, and we commend the Board's efforts in this regard. We also commend the Board for including the commentary comparing its proposed standards and the ISAs. Such analysis provides useful insight to the Board's rationale for such differences. We encourage the Board to continue this practice. However, we urge the Board to participate in the work of, and engage with, other standard setting bodies so that collectively plans can be developed to eliminate unnecessary differences. We believe that a collaborative approach among standard setters will facilitate convergence and that such an approach can enhance the effectiveness of all standard setters involved.

Transparency in the Standard Setting Process

We believe the Board has taken important steps to improve the transparency of its standard setting process, most notably its recent use of concept releases to elicit earlier public input and its reexposure of proposals.

We also see positive signs of increased transparency within the proposed standards, including more in-depth discussion of constituent comments and their disposition, and enhanced

commentary comparing the proposal with the ISAs. We appreciate these efforts and, consistent with Chairman Daniel L. Goelzer's comments at the December 17, 2009 open meeting, we urge the Board "to continue to explore ways of making its standard setting - and the thinking that underlies its proposals - more open." We encourage the Board to address in particular the matters discussed below.

1) *Nature, Timing and Extent of Public Involvement in the Standard Setting Process*

We acknowledge the important role that the Board's Standing Advisory Group (SAG) and its inspection process play in informing the Board's agenda. We also acknowledge and encourage the Board's recent efforts to increase the depth and accelerate the timing of public involvement, including the auditing profession, in providing input to its standard setting process. We believe that this can be done transparently and effectively without compromising the independence of the standard setting process. As an example, we encourage the Board to establish external task forces, consisting of members of the auditing profession, investors, academics, and other relevant parties, to participate in developing new standards. This could provide the Board with an opportunity to obtain public input during the development stage of a standard, prior to its release for public comment. We believe that such a process would enhance the quality, timeliness and efficiency of the development process and complement the role of the SAG and the other forums that currently inform the Board's standard setting activities.

2) *Use of Release Text to Provide Guidance*

In some situations, it appears that the Board is providing application guidance and interpretations in the release that accompanies the final standard. Interpreting standards through release text can result in potential confusion over the intent of the requirements within the related standard. In addition, because the release is not ultimately part of the final standard (i.e, not part of the "Rules of the Board" that are approved by the SEC), it is important that guidance considered necessary to understand the requirements of the standard be included in the standard. For example, we believe that certain content from the Board's commentary in Appendix 9, shown below in italics for identification, relating to the proposed conforming amendments to AU 350, *Audit Sampling*, should be included in the standard.

The original proposal included amendments to AU secs. 350.23 and 350.38, which would explain more specifically how the principles in the standard for determining sample sizes when nonstatistical sampling approaches are used. Some commenters expressed concerns that the proposed amendments would have required auditors who use nonstatistical sampling methods to compute sample sizes under both statistical and nonstatistical methods to demonstrate that the sample size under the nonstatistical method equaled or exceeded sample size under a statistical method. *The proposed amendments are not intended to require auditors to compute sample sizes using statistical methods in all instances to demonstrate compliance with the requirements. For example, the use of a nonstatistical sampling method that is adapted appropriately from a statistical sampling method also could demonstrate compliance* (italics added). Accordingly, these amendments are retained as originally proposed.

In order to incorporate the above interpretive guidance into the standard, and as stated in our February 18, 2009 comment letter on the Board's prior proposal, we recommend that the Board restore footnote 5 from extant AU 350 at the end of paragraph 23A of the proposed conforming amendments to AU 350, and additionally include a footnote reference at the end of paragraph 38 referring back to that footnote. Footnote 5 states "This guidance does not suggest that the auditor using nonstatistical sampling compute a corresponding sample size using statistical theory."

3) *Highlight Expected Changes to Practice in Proposed Standards*

We note that Board member Charles D. Niemeier suggested at the Board's December 17, 2009 open meeting that the PCAOB should more clearly express what they want to change in auditor performance as part of the release of a proposed standard. We agree that this would be extremely helpful to facilitate the public comment process. We therefore encourage the Board to include a listing of the interim standards that are being amended or superseded together with a concise summary of what the Board intends to change with respect to auditor performance in the introductory text of a proposed standard. When relevant, references might also be included to other sections of the release text to provide further insights with respect to proposed changes.

4) *Marked Comparisons to Prior Proposals and Extant Standards*

When standards are repropose, we believe the Board should provide a marked version of the new proposal to facilitate the identification of the changes from the original proposal. Although this would be helpful for any reproposal, it would be particularly helpful for larger projects with relatively short comment periods such as this one.

In addition, when the Board proposes extensive conforming amendments to its standards, we believe the Board should provide the entire text of the extant standard marked for the proposed changes to allow commenters to better evaluate the impact of the changes. In particular, the proposed conforming amendments to the Board's interim standard AU 316, *Consideration of Fraud in a Financial Statement Audit*, significantly affect that standard. Issuance of the full standard marked for the proposed amendments would allow commenters to more effectively consider the extent and implications of the proposed changes.

Effective Date

We believe the proposed effective date (for audits of fiscal years beginning on or after December 15, 2010) may be aggressive in light of the need to consider public comment and revise and adopt final standards, while allowing sufficient time for the SEC to expose and approve the standards. Given the scope of the proposed standards and the significance of the changes from current standards, and because the proposals are relevant to the planning process, we believe audit firms around the world should be provided additional time to incorporate the standards into their audit methodology and to complete related training programs prior to the beginning of the year in which the proposed standards would apply.

Therefore, to the extent the final standards are not approved by the Board and the SEC by approximately June 30, 2010, we strongly request that the Board consider a later effective date.

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We appreciate the opportunity to express our views and would be pleased to discuss our comments or answer any questions that the PCAOB staff or the Board may have. Please contact Michael J. Gallagher (973-236-4328), Brian R. Richson (973-236-5615) or Brian T. Croteau (973-236-4345) regarding our submission.

Sincerely,

PriceWaterhouse Coopers LLP

Attachment

Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards

This appendix provides our detailed comments specific to each of the seven proposed standards and the related amendments to PCAOB standards for the Board's consideration.

Appendix 1: Audit Risk

Paragraphs 9 and 10

- We believe the proposed standard would be improved by incorporating additional guidance from the Board's interim standards that articulates more clearly how the auditor applies the audit risk model in performing the audit. In particular, we do not believe the linkage between the auditor's assessment of inherent and control risk and auditor's determination of the acceptable level of detection risk is as clear in the proposed standard as it is in the Board's interim standards. We recommend that the Board consider incorporating into paragraph 9 of the proposed standard the first sentence of paragraph 81 of AU 319, *Consideration of Internal Control in a Financial Statement Audit*, and also align the guidance in paragraph 10 more closely with that in paragraph 28 of AU 312, *Audit Risk and Materiality in Conducting the Audit*, as shown below. These proposed revisions will also create better linkage between this standard and the discussion of the auditor's control risk assessment in the proposed standard *The Auditor's Responses to the Risks of Material Misstatement*.

Detection Risk

9. In the audit of the financial statements, detection risk is the risk that the procedures performed by the auditor will not detect a misstatement that exists and that could be material, individually or in combination with other misstatements. ***The auditor uses the assessed level of control risk (together with the assessed level of inherent risk) to determine the acceptable level of detection risk for financial statement assertions.*** The level of detection risk is reduced by performing substantive procedures. Detection risk is affected by the effectiveness of the substantive procedures and of their application by the auditor.

10. For a given level of audit risk, the acceptable level of ~~d~~ Detection risk bears an inverse relationship to ~~the risk of material misstatement~~ ***inherent and control risk*** the risk of material misstatement at the assertion level. The ~~less~~ lower the ***inherent and control risk the auditor believes exists*** of material misstatement, the greater the detection risk that can be accepted. Conversely, the greater the ***inherent and control risk the auditor believes exists*** 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.

Appendix 2: Audit Planning and Supervision

Paragraph 14

- We believe the requirement to "vary the nature, timing, and extent of audit procedures at locations or business units from year to year" is overly prescriptive because it limits

flexibility in determining the acceptable methods of introducing unpredictability in the procedures performed in multilocation audits.

In contrast, paragraph 5(c) of proposed auditing standard *The Auditor's Responses to the Risks of Material Misstatement*, to which reference is made in the paragraph 14, permits such flexibility and identifies the following examples of ways in which unpredictability can be incorporated in the selection of audit procedures to be performed, including, for example, by changing the locations selected for testing from year to year:

5(c)...Examples of ways to incorporate an element of unpredictability are (a) performing audit procedures related to accounts, disclosures and assertions that would not otherwise be tested based on their amount or the auditor's assessment of risk; (b) varying the timing or location of the audit procedures; (c) selecting items for testing that have lower amounts or are otherwise outside customary selection parameters; and (d) performing audit procedures on an unannounced basis.

We recommend deleting paragraph 14 and adding "varying the nature, timing and extent of audit procedures at locations or business units from year to year in multilocation audits" as another example in paragraph 5(c) of proposed standard *The Auditor's Responses to the Risks of Material Misstatement*.

Footnote 12

- This footnote, shown below, is based on paragraph 37 of Interpretation 3, "Responsibility of Assistants for the Resolution of Accounting and Auditing Issues," of the Board's interim standard AU 311, *Planning and Supervision*, which will be superseded on adoption of the proposed standard. We believe the footnote suggests that this guidance is included in the Board's interim standard AU 230, *Due Professional Care in the Performance of Work*, when it is not. We believe this is helpful application guidance that should be added to paragraph 23(b) of the proposed standard and the footnote deleted.

¹² In applying due professional care in accordance with AU sec. 230, each engagement team member has a responsibility to bring to the attention of appropriate persons, disagreements or concerns the engagement team member might have with respect to accounting and auditing issues that he or she believes are of significance to the financial statements or auditor's report, however those disagreements or concerns may have arisen.

Appendix 4: Identifying and Assessing Risks of Material Misstatement

Paragraph A5

- We believe that the definition of "significant risk" should be revised as shown below to make it clear that these are risks that are designated as such by the auditor.

A5. Significant risk —A risk of material misstatement that ***the auditor determines*** requires special audit consideration.

Paragraph 11

- We recommend modifying the introductory language as shown below to provide appropriate flexibility for the auditor to tailor the application of this requirement, including the nature and extent of procedures performed, to facts and circumstances of each audit. For example, we are concerned that "obtaining information about trading activity in the company's securities and holdings in the company's securities by significant holders to identify potentially significant unusual developments (e.g., from Forms 3, 4, 5, 13D and 13G)" might result in auditors expending significant efforts to obtain, review, and document such information without a commensurate increase in audit quality.

11. The auditor also should consider **whether and to what extent to** performing the following procedures as part of obtaining an understanding of the company:

Paragraph 13

- The terminology "necessary disclosures" in the last sentence of this paragraph should be clarified to make an explicit link to the disclosures required by the applicable financial reporting framework. In addition, we believe the requirement to identify disclosures should be modified to incorporate the clarifying language about the requirement from page A9-30 of the Board's proposal which seems more consistent with the context of obtaining an understanding of the company's selection and application of accounting principles. Accordingly, we recommend changing the last sentence as shown below:

13. As part of obtaining an understanding of the company's selection and application of accounting principles, including related disclosures, the auditor should evaluate whether the company's selection and application of accounting principles is appropriate for its business and consistent with the applicable financial reporting framework and accounting principles used in the relevant industry. Also, to identify and assess risks of material misstatement related to omitted or incomplete disclosures, the auditor should **develop expectations about the types of** ~~identify the necessary~~ disclosures for the company's financial statements **that are required by the applicable financial reporting framework.**

Paragraph 20

- We suggest in our comment letter that the Board retain paragraphs 64-65 as optional guidance on walkthroughs and move these paragraphs, as proposed to be amended, to follow paragraph 20. If the Board does not accept this suggestion, we recommend adding a sentence to the second Note in paragraph 20 that states "walkthroughs that include these procedures ordinarily are sufficient to determine that a control has been implemented" to clarify that walkthroughs are sufficient for evaluating not only the design of a control, but also whether a control has been implemented.

Paragraph 42

- We believe the requirement in this paragraph should be aligned with Interpretation 1, "Communications Between the Auditor and Firm Personnel Responsible for Non-Audit Services" (AU 9311.01-.03) of the Board's interim standard AU 311, *Planning and Supervision* to allow for the exercise of judgment in determining which services are likely to be relevant to the auditor's risk assessment rather than creating a mechanical

requirement that is not based upon risk or judgment. Accordingly, we recommend the revisions shown below:

42. The auditor should consider the nature of non-audit services that have been performed for the company and assess whether the services involve matters that might be expected to be ~~If the auditor has obtained other information relevant to identifying risks of material misstatement through other engagements performed for the company, the auditor should take that into account in identifying risks of material misstatement.~~

Paragraph 54

- We recommend that the Board include additional language from paragraph 24 of the PCAOB's extant AU 316, the source for paragraph 54, in the second sentence of this paragraph as shown below. Retaining the extant language will make clear that the auditor is to make a determination about the extent of such inquiries and explicitly relates the need for these inquiries to the risks of material misstatement.

54. . . . The auditor should identify other individuals within the company to whom inquiries should be directed **and determine the extent of such inquiries** by considering whether others in the company might have additional knowledge **that will be helpful to the auditor in identifying risks of material misstatement due to** ~~about~~ fraud, alleged or suspected fraud....

Paragraph 56

- Paragraph 56d requires auditors to consider the likelihood and magnitude of potential misstatements to assess the possibility that the risk could result in a material misstatement of the financial statements. However, we note that paragraph 56f, which requires auditors to determine whether any of the identified and assessed risks of material misstatement are significant risks, does not contain similar language related to an auditor's consideration of likelihood and magnitude when evaluating whether an identified risk is a significant risk. While the Note to 56f correctly states that the determination of significant risk is based on inherent risk, without regard to the effect of controls, we believe an auditor's evaluation of whether or not a risk is significant includes consideration of the likelihood and magnitude of the risk of misstatement. These considerations include the ability to control the risk (i.e., as opposed to how a risk is actually controlled). For example, the degree to which a risk tends to be subject to systematic processing and the degree of required management judgment involved influences relevant likelihood considerations in determining significant risks. As such, we recommend the Board clarify that likelihood and magnitude are factors for consideration in significant risk determinations.

Appendix 5: The Auditor's Responses to the Risks of Material Misstatement

Paragraph 2

- We are pleased about the addition of "assessed" preceding "risks" throughout the standard because it incorporates the linkage between the auditor's risk assessment and the auditor's response that was missing in the prior proposal. For similar reasons, we believe the objective of the auditor in this standard should also include "assessed" risk terminology.

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

Paragraph 6

- We believe that using the term "pervasive" to characterize changes to the nature, timing and extent of audit procedures described in this paragraph is both unclear and unnecessary. We recommend deleting the term.

Paragraph 16

- We recommend deleting footnote 8 to this paragraph which states "Reliance on controls, when appropriate, allows the auditor to assess control risk at less than the maximum, which results in a lower assessed risk of material misstatements. In turn, this might allow the auditor to modify the nature, timing, and extent of planned substantive procedures." We believe the footnote is unnecessary and the "might allow" language also appears to be inconsistent with the auditor's ability to modify the nature, timing and extent of substantive procedures based on an appropriately supported control risk assessment that is below the maximum.

Appendix 6: Evaluating Audit Results

Paragraph A2

- We suggest changing the order of the first and second sentences in the definition of misstatement so that the discussion of material misstatement follows the identification of sources of misstatement.

Paragraph 15

- We recommend that the PCAOB incorporate paragraph 9 of ISA 450, which requires the auditor to obtain an understanding of management's reasons for not correcting misstatements and to take that understanding into account when evaluating whether the financial statements as a whole are free of material misstatement, after paragraph 15 of the proposed standard.

Appendix 7: Audit Evidence

Overall

- The term "persuasive" is used in the proposed standard *The Auditor's Responses to the Risks of Material Misstatement* and in other areas of the Board's interim standards to describe the nature of evidence obtained through the audit. However, "persuasive" is not described in the proposed *Audit Evidence* standard despite the fact that it is intended to describe a characteristic of audit evidence. We believe that its lack of use in this standard, which provides guidance related to the evaluation of audit evidence, may lead to confusion as to how the persuasiveness of audit evidence affects an auditor's consideration of the sufficiency and appropriateness of audit evidence. Therefore, we recommend the Board

consider clarifying the manner in which the persuasiveness of evidence impacts the evaluation of audit evidence within this standard.

Paragraph 18

- The second sentence of this paragraph in the prior proposal, which stated "Written confirmations might be received in paper form, or by electronic or other medium," has been omitted. We believe this sentence should be restored because paragraph 29 of the PCAOB's interim standard AU 330, *The Confirmation Process*, presumes that confirmations will be written by stating: "There may be situations in which the respondent, because of timeliness or other considerations, responds to a confirmation request other than in a written communication mailed to the auditor. When such responses are received, additional evidence may be required to support their validity."

We understand that the PCAOB is considering a proposed revision of AU 330; however, we believe the concept that confirmations are written responses should be restored to paragraph 18 so that the proposed standard is consistent with extant AU 330.

Appendix 8: Proposed Conforming Amendments to PCAOB Standards

- We suggest replacing "evidential matter" with "audit evidence" in the proposed conforming amendments addressed in item "d" of AU sec. 329, *Analytical Procedures* and in item "b" of AU sec. 350, *Audit Sampling*." In addition, we suggest adding a third bullet to the proposed conforming amendment addressed in item "i" of AU sec 329 to replace "evidential matter" with "audit evidence" in the third sentence of paragraph .21.