

February 18, 2009

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

Re: PCAOB Rulemaking Docket No. 026, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Conforming 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 Conforming Amendments to PCAOB Standards* (the "standards," "proposed standards" or "proposals").

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 concur with the Board that risk assessment, appropriately applied, should underlie the entire audit process and result in audit procedures that are tailored to a company's facts and circumstances, including its size and complexity. We therefore support the Board's objective to update its existing interim standards to reflect improvements that firms have made in risk-based audit methodologies. We also appreciate the Board's efforts to consider recommendations on potential ways to further improve risk assessment (e.g., the 2000 report by the Panel on Audit Effectiveness, and feedback from the PCAOB's Standing Advisory Group (SAG)). Some of these same recommendations served as the impetus for the AICPA's Auditing Standards Board (ASB) and the International Auditing and Assurance Standards Board (IAASB) to form a joint task force in 2001 that culminated in the development of a common set of risk assessment auditing standards intended to improve audit quality and to support convergence of auditing standards.

We acknowledge the challenge of drafting risk assessment standards that provide sufficient direction to the auditor to identify, assess and respond to risk appropriately, yet do not impede the necessary exercise of professional judgment on which a risk-based audit depends. It is critical that auditors use sound professional judgment to identify and address those risks that, if not addressed, affect the auditor's ability to obtain reasonable assurance that the financial statements are free from material misstatement. It is also important, however, to balance the need for a thorough risk assessment process with one that gives appropriate consideration to the attendant cost-benefit considerations. Auditors must be able to make judgments about the severity of the risks identified so that the level of effort to respond to each risk is commensurate with its significance to a particular audit. We believe that improvements can be made to the proposed standards to better address these considerations.

In the remainder of our letter, we have organized our overall observations and concerns about the proposal into the following topical areas:

- Convergence of auditing standards
- Importance of auditor application of professional judgment
- Importance of the linkage between assessed risks and the auditor's response
- Risk assessment process: consistency and integration with Auditing Standard No. 5 (AS 5)
- Organization and content of standards
- Integration of fraud guidance
- Considerations related to the finalization of the proposed standards

In addition, we have provided comments and recommendations regarding codification of the PCAOB's standards and increased public involvement in the PCAOB's standard-setting process, particularly through the use of task forces with representatives from the auditing profession and by participation in task forces with other standard setters.

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

Convergence of Auditing Standards

We fully support the Board's consideration of the work of other standard setters, as evidenced by the overall alignment of the proposal's general structure with the corresponding risk assessment standards of the IAASB and the ASB. We also recognize the efforts of the Board to participate in the work of other standard setters by PCAOB staff attending and participating in IAASB meetings, inviting the IAASB Chairman to join the SAG meetings, and participating in joint meetings of standard setters.

While significant steps have been taken, the PCAOB can achieve even greater benefits by more fully implementing the objective in its 2008-2013 strategic plan to "participate in the work of, and engage with, other standard-setting bodies to benefit from, and as appropriate incorporate, new developments and techniques to promote high quality audits worldwide." In particular, we encourage the Board to consider using the International Standards on Auditing (ISAs) as the base from which to develop its standards, as other national standard setters are doing, and add to or modify the ISA wording for requirements and guidance only as the Board deems necessary for audits, including integrated audits, of issuers. We also encourage the Board to work together with other standard setters to eliminate unnecessary differences and achieve greater convergence of standards.

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. A more collaborative approach among standard setters will enhance the effectiveness and efficiency of standard-setting processes; improve the global understanding of auditing standards both by auditors and by other interested parties; eliminate unnecessary differences among the standards; and clarify the rationale for and understanding of differences that remain, such as those necessitated by an integrated audit performed for legal or regulatory reasons. These benefits will enhance auditors' understanding, implementation, and consistent

application of standards on *all* audits they perform, including those subject to the Board's oversight. Additionally, appropriate convergence allows firms to avoid adding unnecessary costs to audits, for example, by allowing for synergies related to training, implementation, and the development and maintenance of quality control systems that provide reasonable assurance regarding compliance with the standards of the various standard-setting bodies.

We acknowledge and support the Board's published analysis of significant differences between its proposed standards and those of the corresponding ISAs. In this regard, we agree with the following remarks made by Board member Bill Gradison at the Board's October 21, 2008 open meeting:

"For the first time, the PCAOB is putting out a new standard for comment that includes an extensive comparison of its proposal with the standards promulgated by another standard setter, in this case the Risk Assessment Auditing Standards of the International Auditing and Assurance Standards Board – the so-called ISAs. I would hope that the PCAOB would continue to put out such comparative information in connection with future proposals for new PCAOB standards. We are fast entering an auditing environment with three differing standards, especially as the PCAOB gradually replaces its interim standards (the pre-2003 ASB standards) and the ASB revises its standards, using the ISAs as the base – that is, "ISAs plus." I don't know whether over the long run having three standards is sustainable, but as long as there are three standards I believe each standard setter has a responsibility to make it as clear as possible how its standards differ from those of the other two standard setters so that practitioners know what is expected of them. Today's Board action is, in my mind, a constructive step in that direction."

In light of the increasing global acceptance of the ISAs, we encourage the Board to provide a more detailed comparison of its proposed standards and those of the IAASB. This could be achieved, as recommended above, by starting with the comparable ISA in developing the Board's standards to facilitate more robust comparison of the standards and to clearly identify where, and why, the Board believes divergence from the ISAs is necessary.

Our detailed comments in the Appendix to this letter identify areas in which we believe greater convergence could be achieved without jeopardizing the Board's objective to issue robust standards directed to audits, including integrated audits, of issuers.

Importance of Auditor Application of Professional Judgment

We acknowledge and agree with the Board's statement in its release accompanying the proposed standards of the importance to the audit process of auditors' exercising sound professional judgment to determine how best to fulfill the requirements of the proposed standards under particular circumstances. We also acknowledge the Board's statement in paragraph A19 of the appendix to Auditing Standard No. 3, *Audit Documentation*, that "...because professional judgment might relate to any aspect of an audit, the Board does not believe that an explicit reference to professional judgment is necessary every time the use of professional judgment may be appropriate." While not disagreeing with the Board's prior conclusion, we nonetheless believe it is particularly important to acknowledge the need for the auditor's professional judgment within these proposed standards which establish the fundamental principles of the audit and rely on the use of professional judgment to appropriately apply the standards to the unique circumstances of each audit engagement. It is important to recognize that the judgments made regarding the identification and assessment of risks; the nature, timing and extent of audit procedures to address those risks; and what constitutes sufficient evidence are necessarily dependent on the facts and circumstances known to the auditor during the conduct of the engagement. Although such judgments are

particularly susceptible to second-guessing, the concept of a risk-based audit is dependent on the exercise of professional judgment.

In addition, we believe some presumptively mandatory requirements in the proposed standards are unnecessarily prescriptive and could have the unintended consequence of encouraging a checklist approach rather than promoting the exercise of professional judgment to appropriately scale and tailor the risk assessment process, and the related audit response, in each audit.

Importance of the Linkage between Assessed Risks and the Auditor's Response

We note that the linkage between the auditor's assessment of risk and the performance of audit procedures responsive to that risk—one of the more significant improvements resulting from the IAASB's and ASB's reconsideration of performing a risk-based audit—has not been incorporated into the proposed standards. The linkage between the assessment of risk and the audit response is a fundamental concept in performing a risk-based audit. We understand that a deficient risk assessment should not be used as justification for an inadequate audit; however, there doesn't seem to be a purpose for assessing risk if the outcome doesn't drive the auditor's response. Without an appropriate assessment of and response to risk, the auditor may not obtain sufficient evidence when there is a higher risk of misstatement (resulting in an ineffective audit) or perform work unnecessarily when the risk of misstatement is low (resulting in an inefficient audit). We recommend that the proposed standards incorporate the concept of linkage, that is, the auditor should design and implement appropriate responses based on the *identified and assessed* risks of material misstatements, which is consistent with ISA 330, *The Auditor's Responses to Assessed Risks*.

In particular, incorporation of the term and concept of "assessed risks" throughout the standards, as has been done in the ISAs, would address this concern and make clear the important linkage between identifying and responding to risks. Further, we believe that the objectives in the proposed standards, *Identifying and Assessing Risks of Material Misstatement* and *The Auditor's Responses to Risks of Material Misstatement*, should be aligned with those in the comparable ISAs to acknowledge this linkage.

Risk Assessment Process: Consistency and Integration With Auditing Standard No. 5 (AS 5)

We encourage the Board to reconsider ways in which to better integrate its guidance for performing an integrated audit, including the consideration of audit risk in an integrated audit (see overall comment in the Appendix on the proposed standard *Audit Risk in an Audit of Financial Statements*). We understand that the proposed standards are intended to be suitable for audits only of financial statements as well as for integrated audits. However, we find that the Board's approach to combining the proposed standards with Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements* (AS 5), is inconsistent and in some cases potentially confusing. Our long-standing views about the need to provide integrated risk assessment guidance for the integrated audit were articulated by Ray Bromark, then the leader of PwC's National Office, when the PCAOB first discussed "Risk Assessment in Financial Statement Audits" at its February 16, 2005 SAG meeting. Specifically, Mr. Bromark observed the following:

"...now that we have moved to an integrated audit and reporting on the effectiveness of an internal control system, I think that changes the dynamic a fair amount on what risk it is we're assessing...as we move the mentality from financial statement audits to integrated audits, I think it's incredibly important that we expand our thinking in the area of risk assessment to the integrated audit."

Notwithstanding the different objectives of the audits (i.e., identification of material misstatements versus identification of material weaknesses), we believe that in an integrated audit the risk assessment process is generally the same for both the audit of the financial statements and the audit of internal control over financial reporting (ICFR). The fundamental requirements to obtain an understanding of the entity, including its internal control, and its inherent risks as a basis for assessing the risk of material misstatement are applicable in both the financial statement and ICFR audits. Once the risks of material misstatement have been identified and assessed, the auditor's responses to those risks may differ depending on whether an integrated audit or a financial statement only audit is performed. We are concerned that the Board's proposed risk assessment standards may encourage a "side-by-side," rather than an integrated, approach to risk assessment for auditors performing an integrated audit.

For example, the guidance about the auditor's understanding of the components of internal control in the proposed risk assessment standards should be better aligned with related guidance in AS 5. In particular, AS 5 paragraphs 34-38, "Understanding Likely Sources of Misstatement," and paragraphs 22-27, "Identifying Entity-Level Controls" are different from the guidance on understanding the components of internal control in *Identifying and Assessing Risks of Material Misstatement*. The differences suggest that a parallel rather than an integrated understanding is necessary to identify and assess risk in the audit of ICFR and the financial statement audit.

In addition, there is considerable redundancy between guidance in the proposed standards and that in AS 5. Such redundancy should be eliminated as it may also create confusion. If guidance in AS 5 is equally relevant to an audit only of financial statements, it should be incorporated into the risk assessment standards and replaced in AS 5 with a cross-reference to the risk assessment standards. An example of such guidance is paragraph 7 of the proposed standard *Audit Planning and Supervision* which is incorporated from paragraph 9 of AS 5. In contrast, there is guidance incorporated from AS 5 in the proposed risk assessment standards that would be relevant only when the auditor is performing an integrated audit. In such circumstances, the guidance should remain in AS 5 and the risk assessment standards should include only a cross-reference. An example of such guidance is paragraphs 41-44 of the proposed standard *Evaluating Audit Results*.

Finally, there is a significant inconsistency between the risk assessment proposals and AS 5 in that the "top-down approach" permeates AS 5, but is not mentioned in the proposed standards. We believe that the top-down approach is also relevant to the audit of the financial statements and should be addressed by the Board in the proposed standards.

Organization and Content of Standards

Objectives

We support the inclusion of a principles-based and outcome-oriented objective in each of the proposed standards. If objectives are going to be introduced to PCAOB standards, however, the PCAOB should consider from the outset how the objectives of individual standards are intended to fit into the overall framework of PCAOB standards. In the ISAs, for example, objectives of individual standards are intended to assist the auditor in planning and performing the audit to achieve the overall objectives of the audit as set forth in ISA 200. As stated in paragraph 20 of ISA 200, the auditor should use the objectives in relevant ISAs to (a) determine whether any audit procedures in addition to those required by the ISAs are necessary in pursuance of the objectives stated in the ISAs, and (b) evaluate whether sufficient appropriate audit evidence has been obtained. The Board should consider adding objectives to all of its standards, not just the seven in the proposal, and similarly link them to overarching guidance that provides context for their use.

We do not believe it is appropriate for objectives in individual standards to contain the words "must" or "should" governed by the Board's Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards*. Such words should be reserved for the requirements that support the objectives of the standards. Accordingly, we recommend that paragraph 3 of the proposed *Audit Planning and Supervision* standard be removed from the "objective of the auditor" section of that proposed standard.

Finally, we believe that some objectives proposed by the Board are overly broad (e.g., those in *Evaluating Audit Results* and *Audit Evidence*) and the linkage between others should be improved (e.g., *Identifying and Assessing Risks of Material Misstatement* and *The Auditor's Responses to the Risks of Material Misstatement*).

Appropriate balance between requirements and guidance

While we generally support the brevity of the proposed standards, there are some areas in which the proposal would be improved with additional explanatory guidance, some of which is included in extant PCAOB, IAASB or ASB standards. For example, paragraph 19 of the proposed standard *The Auditor's Responses to the Risks of Material Misstatement* requires the auditor to perform tests of controls "for each relevant assertion for which substantive procedures alone cannot provide sufficient appropriate audit evidence," but the proposed standard provides no guidance to explain when such circumstances arise. The Board should consider including guidance about when this is the case. For example, we believe this is the case under circumstances where a significant amount of information supporting financial statement assertions is electronically initiated, recorded, processed, or reported, as described more fully in paragraphs A120-121 of ISA 315 (Redrafted), *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*. In such cases, the entity's controls over such risks are relevant to the audit and the auditor should obtain an understanding of them. This guidance is also included in paragraphs 119-120 of AICPA AU 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* and in paragraphs 68-69 of the Board's interim standard AU 319, *Consideration of Internal Control in a Financial Statement Audit*.

We also believe that some of the guidance in the proposed standards is unnecessarily prescriptive and will reduce efficiency without a commensurate increase in effectiveness.

For example, paragraph 52(d) of the proposed standard *Identifying and Assessing Risks of Material Misstatement* which requires the auditor to make specific inquiries about fraud of "accounting and financial reporting personnel, including, in particular, employees involved in initiating, authorizing, processing, or recording complex or unusual transactions" is unnecessarily prescriptive, and may result in an extensive volume of inquiries. We suggest that the proposed standard retain the auditor's ability to apply judgment in determining those with whom such discussions are appropriate, which is more consistent with the current guidance in AU 316.25 and paragraph A16 of ISA 240. We agree that the inquiries that are required in paragraphs 52(a), (b), and (c) of management, the audit committee, and internal audit personnel, respectively, are appropriate; however, we believe that the requirement in 52(d) is an unnecessary elevation of guidance.

Inconsistent use of terminology: "should consider," "should evaluate" and "should assess"

We observed numerous instances in the proposed standards (for example, paragraphs 41 and 63 in *Identifying and Assessing Risks of Material Misstatement* and paragraphs 4 and 25 in *Evaluating Audit Results*) in which the Board changes "should consider" guidance drawn from its interim standards or from the ISAs to "should evaluate" or "should assess" guidance. We believe "should consider" provides appropriate direction to auditors in these cases. If the PCAOB decides that it is

necessary to make these changes, the PCAOB should clarify whether the auditor's response and level of documentation are expected to be different under the proposed standard. If not intended to be different, we recommend that the Board restore the "should consider" terminology.

Definitions

We encourage the Board to develop and follow a consistent approach with respect to defining terms. Some of the proposed standards (for example, *Identifying and Assessing Risks of Material Misstatement*) define terms in a Definitions section similar to the redrafted ISAs. Others define terms informally within the text of the standard (for example, the definition of fraud risk in paragraph 4(c) of *The Auditor's Responses to the Risks of Material Misstatement*). AS 5 demonstrates a third approach with a Glossary of defined terms appended to the standard. These differences in approach make the standards more difficult to use and could lead to misunderstanding. We recommend that the Board define terms in a special Definitions section of each standard, as appropriate, and create a Glossary with all defined terms.

Use of notes to paragraphs and appendices

We do not understand the purpose for including Notes within paragraphs of the Board's standards. We recommend that guidance currently in Notes be incorporated into existing or new paragraphs. In addition, to the extent that appendices are used, we recommend that they not include requirements. Requirements should be included in the text of the standard.

Integration of Fraud Guidance

We believe that there are pros and cons to the integration of AU 316, *Consideration of Fraud in a Financial Statement Audit*, into the proposed standards. For firms that already integrate the consideration of fraud throughout the audit process, such as ours, this proposed integration is not likely to result in a significant change to the existing approach. However, the PCAOB's integration of fraud guidance may be of benefit to those practitioners who view fraud procedures as a "bolt on" to other audit procedures rather than as an integrated consideration throughout the audit. Therefore, we believe that the extent of benefit resulting from the proposed integration will be dependent on an auditor's existing approach to fraud procedures.

A potential downside of the proposed integration is that the guidance on fraud is dispersed throughout several standards, which may make it more difficult to obtain a holistic understanding of how the auditor should address the risk of fraud than if the guidance were retained in a single standard.

Considerations Related to the Finalization of the Proposed Standards

Overall review of interim standards

We support the Board's intent, announced at its October 2008 SAG meeting, to issue a concept release for public comment in early 2009 addressing the Board's action plan for review of its interim standards. We question, however, whether issuance of this concept release would have been more appropriate prior to, or simultaneous with, the exposure of the proposed risk assessment standards. Due to the fundamental nature of the proposed standards, we suggest that the Board consider feedback on the concept release in connection with making revisions to these proposed standards prior to adoption.

Effective date

We note that the proposed standards do not include an effective date. We believe the Board should expose the proposed implementation date for public comment prior to issuance of the standards. We encourage the Board to consider the need to provide sufficient time for firms to incorporate the standards into their audit methodology and to implement related training programs prior to the beginning of the year in which the proposed standards would apply.

Codification of the PCAOB's Standards

We acknowledge the Board's efforts to write standards that will serve as a foundation for future standard setting. However, we have difficulty envisioning how these standards will be integrated with the Board's other interim standards and with Auditing Standard Nos. 1 through 6.

Further, adoption of the proposed standards will introduce a third "style" of standard that is inconsistent with the Board's other standards, as previously discussed under Objectives and Definitions in the "Organization and Content of Standards" subsection of this letter. We are unclear how the Board anticipates integrating the various styles in the future. The IAASB and the ASB have both undertaken projects to redraft all of their auditing standards in a consistent manner, with the expectation that this exercise will improve understanding and lead to more consistent application by auditors and, as a result, improve audit quality. We encourage the Board to undertake a similar project to introduce greater consistency and clarity in its standards.

Public Involvement in the Standard-Setting Process

We encourage the Board to increase the depth and accelerate the timing of public involvement, including the auditing profession, in its standard-setting process. We believe that this can be done effectively without compromising the independence of the Board's standard-setting process. We acknowledge the important role that the Board's SAG and its inspection process play in informing the Board's agenda. We also support the remarks of Board Member Dan Goelzer, at the PCAOB's October 21, 2008 open meeting, that the Board might consider additional steps to promote the transparency of the Board's process. Mr. Goelzer suggested potential actions such as publishing a revised proposal, opening a second comment period and holding additional public forums or Board discussions to consider the comments.

While the above recommendations would improve transparency, the quality of the standard-setting process could be significantly enhanced by creating task forces or otherwise more directly involving experienced members of the auditing profession in the development of standards. We envision task forces comprised of experts, including members of the auditing profession, who would deliberate working drafts of auditing standards and provide input to the Board and its staff for consideration during the development stage, prior to the publication of a proposed standard 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.

We also encourage Board members and PCAOB staff to participate in joint task forces with the IAASB and the ASB. In that regard, we strongly support the following views expressed by Bill Gradison to the Colorado Society of CPAs on December 19, 2008:

"...if one sees merit in the quest for a single high-quality set of auditing standards (as I do), or if one sees this as inevitable for the protection of investors in our interconnected world (as I also do), then the challenge is for the three standard setters to develop a road map – a systematic, joint, comprehensive standard-by-standard review.... seeking at



least to eliminate unneeded differences among the present standards and in addition exploring in the interest of investors the adoption of a single set of high-quality internationally accepted auditing standards."

* * * * *

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 Vin Colman (973-236-5390), Jorge Milo (973-236-4300) or Brian Croteau (973-236-4345) regarding our submission.

Sincerely,

A handwritten signature in cursive script that reads "PriceWaterhouseCoopers LLP".

Attachment

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

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

Appendix 1: Audit Risk in an Audit of Financial Statements

Overall

In Appendix 9, the Board asks if the proposed standard appropriately describes audit risk and its component risks. We encourage the Board to obtain additional input, perhaps via a task force involving representatives of the profession and academia or via a public forum, to explore how the audit risk model might be updated in light of the integrated audit. The fundamental nature of the concepts in this proposed standard make it particularly important that similarities and differences between audit risk in a financial statement only audit compared to an integrated audit are addressed. Among other matters, we suggest the Board consider updating the definition of audit risk for an integrated audit to include the risk that the auditor expresses an inappropriate audit opinion on internal control over financial reporting when there is a material weakness in internal control over financial reporting.

In addition, the discussion of the component risks—particularly detection risk—should be reconsidered in the context of the financial statement audit and updated to address the audit of internal control over financial reporting. We note that the first sentence in paragraph 10 of the proposed standard states that "the level of detection risk is reduced through the performance of substantive procedures." For the auditor performing an integrated audit, the performance of substantive procedures informs the audit of internal control over financial reporting, but the risk that a material weakness remains undetected is primarily reduced by performing tests of controls. For the auditor performing an audit only of financial statements, we believe that the sentence should be deleted or clarified. Many auditors perform a combined assessment of inherent and control risks (i.e., a combined assessment of the "risks of material misstatement"), which is the approach taken in the IAASB and ASB standards as well as an acceptable approach in the Board's extant interim standard (AU 312.31). When making a combined assessment, the auditor's detection risk is affected by tests of controls and risk assessment procedures as well as by substantive procedures.

Appendix 2: Audit Planning and Supervision

Overall

References to an integrated audit or the audit of internal control over financial reporting are limited to paragraph 7 and a Note in paragraph 11. The guidance in this standard is equally applicable to integrated audits which could be recognized more clearly by incorporating the phrase "whether performing an audit only of the financial statements or an integrated audit" in key paragraphs such as paragraphs 5, 8, 10, 13, and 18.

Paragraph 3

- We do not believe that objectives should include unconditional or presumptively mandatory requirements. We suggest that the paragraph either be deleted or split into two

unconditional requirements, one on planning which would precede paragraph 4 under the subhead "planning an audit," and the other on supervision, which would precede paragraph 18 under the subhead "supervision."

- The statement that "the auditor *must* [emphasis added] adequately plan the audit and properly supervise the members of the engagement team," is inconsistent with paragraph 9 of AS 5 which states that "the auditor *should* [emphasis added] properly plan the audit of internal control over financial reporting and properly supervise any assistants." We recommend that the Board eliminate inconsistencies in the use of these terms.

Paragraph 7

- The bullet points in paragraph 7 repeat those in paragraph 9 of AS 5 unnecessarily. We believe the guidance in paragraph 7 is equally relevant to an audit only of financial statements as it is to an integrated audit. We recommend that the guidance in the proposed standard be retained and that paragraph 9 in AS 5 be replaced with a cross reference to this guidance. Such a change will encourage audit integration through integration of the standards.

We also recommend including in paragraph 7 of the proposed standard the Note to paragraph 9 of AS 5 which provides useful guidance concerning companies with less complex operations. Footnote 8 to the 4th bullet point of paragraph 12 in Appendix 3, *Identifying and Assessing Risks of Material Misstatement*, should then be changed to refer back to paragraph 7 of this proposed standard rather than to AS 5.

- Several of the bullet points in paragraph 7 (i.e., the first, fifth, and ninth bullets), while important to the auditor's understanding of the company, are not intrinsically important to the company's financial statements and internal control over financial reporting. Accordingly, we recommend clarifying the introduction to the bullet points as follows:

When developing the audit strategy and audit plan as discussed in paragraphs 8-10, the auditor should evaluate whether the following matters are important to **the auditor's understanding of** the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures.

Paragraph 9

- In paragraphs 9(b) and 9(c), the auditor "should determine" matters that the auditor following paragraph 7(c) and (d) of ISA 315 "should consider." We believe "should consider" provides appropriate direction. If not adopted, the PCAOB should clarify whether the auditor's response and level of documentation are expected to differ under the proposed standard.
- We suggest changing the wording in paragraph 9(b) to "Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts" to conform to paragraph 7(c) of the ISA, which is clearer.

Paragraph 10

- We recommend that the Board replace the phrase "develop a written audit plan" in this paragraph with "develop and document an audit plan" to be more consistent with Auditing Standard No. 3, *Audit Documentation*, which clarifies in paragraph A3 that "audit documentation may be in the form of paper, electronic files, or other media."

Paragraph 11

- The factors that an auditor "should evaluate" in this paragraph are factors that the auditor "should consider" in existing PCAOB interim standard AU 312.18. We believe "should consider" provides appropriate direction. If not restored, the PCAOB should clarify whether the auditor's response and level of documentation are expected to change under the proposed standard.
- The Note in this paragraph directs the auditor performing an integrated audit to paragraphs B10-B16 of Appendix B of AS 5 for incremental guidance on scoping decisions in multilocation audits. We believe some aspects of the guidance in paragraphs B10-B13 are also relevant for an audit only of financial statements and should be adapted as necessary, moved to this standard, and replaced in AS 5 with a cross-reference to this standard.
- We suggest inserting "consolidated" before "financial statements" in paragraph 11(c).

Paragraph 12

- We recommend replacing the words "or the discovery of a previously unidentified fraud risk" with the words "or the discovery of a previously unidentified risk of material misstatement due to fraud (fraud risk)" to clarify the meaning of "fraud risk" and to be consistent with paragraphs 28(a) of Appendix 3, 4(c) of Appendix 4 and 5(d) of Appendix 5.

Paragraph 15

- We believe that the guidance in paragraph 15 applies to all specialists and not just those with IT skills. Therefore, we suggest modifying the introductory sentence preceding the bullet points to: "if an individual with specialized ~~IT~~ skill or knowledge employed or engaged by the auditor's firm participates in the audit, the auditor should have sufficient ~~IT-~~related knowledge to enable the auditor to..." This is consistent with paragraph 11 of the ASB's proposed standard *Planning an Audit* (Redrafted).

Appendix 3: Identifying and Assessing Risks of Material Misstatement

Overall

Unlike AS 5, the proposed standard does not discuss the use of a top-down approach as part of identifying and assessing risk. We believe that the top-down approach is also fundamental to the process of identifying and assessing risks of material misstatement of the financial statements. We recommend that the Board address the top-down approach in this proposed standard.

In addition, guidance about the components of internal control in this proposed standard should be better aligned with related guidance in AS 5. There are differences in the way that controls are

described in the two standards which suggest that a parallel rather than an integrated understanding is necessary to assess risk in the audit of internal control over financial reporting and in the financial statement audit. In particular, AS 5 paragraphs 34-38, "Understanding Likely Sources of Misstatement," and paragraphs 22-27, "Identifying Entity-Level Controls" could be better integrated with the discussion of internal control in the proposed standard.

Paragraph 3

- In order to reinforce an important linkage between assessing risk and audit response, we recommend that the Board adopt the objective in ISA 315, as follows:

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 level, through understanding the entity and its environment, including the entity's internal control, *thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement* [emphasis added].

Paragraph 4

- We believe the PCAOB definition of significant risk should include the reference in the ISA definition to "identified and assessed risk," as shown below, rather than just "risk." The auditor first identifies risk, and then assesses that risk, followed by a need to plan the audit procedures accordingly. We therefore think "identified and assessed risk" is more accurate relative to the risk assessment process.

Significant risk—An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

If the Board decides to retain the term "important enough" in the phrase "a risk of material misstatement that is *important enough* to require special audit consideration," the Board should provide guidance to clarify the meaning of "important enough."

Paragraph 5

- We do not believe that "obtaining sufficient appropriate audit evidence" is a meaningful concept solely in the context of identifying and assessing risk. We recommend rewording paragraph 5 as shown below:

The auditor should perform risk assessment procedures to **provide a basis for the identification and assessment of** ~~obtain sufficient appropriate evidence to identify and appropriately assess~~ the risks of material misstatement due to error or fraud and to design further audit procedures.

Paragraph 6

- We recommend narrowing the scope of paragraph 6(c) to "other engagements **performed by the engagement partner for the entity**," consistent with ISA 315 paragraph 8. Particularly on large global audits, it is not practical to expect the auditor to assess information obtained on all engagements performed by the audit firm for the client.

- We suggest that the PCAOB consider repeating the AS 5 definition of internal control over financial reporting, including the related discussion of the inherent limitations of internal control over financial reporting, in this proposed standard and then deleting footnote 5 to paragraph 6(b).

Paragraph 12

- When considered with paragraphs 8 and 9b, this paragraph may be overly prescriptive regarding the auditor's performance related to each of the bulleted items in the list. While we acknowledge that each of these items can be important to consider, we believe that they should be presented as examples to allow the auditor to scale and tailor the audit. For example, the requirement to obtain an understanding of "the relative profitability of key products and services" as part of understanding sources of the company's earnings is more relevant in some situations than others.

Paragraph 13

- In order to preserve the ability to exercise professional judgment, the items identified in this paragraph should be characterized as application guidance that the auditor may perform, consistent with ISA 315. Some of these items are overly broad ("reading public information about the company" with no qualifiers as to source) while others are too granular to apply every year for all public company engagements ("obtaining information about significant unusual developments regarding trading activity in the company's securities"). We believe this is an example of overly prescriptive guidance that favors a checklist approach and inappropriately limits the exercise of professional judgment.

Paragraphs 16-17

- We recommend clarifying the guidance on performance measures. Application guidance from paragraphs A32-A36 of ISA 315 may provide source material. In particular, the meaning of the second bullet point in paragraph 17 is unclear.

Paragraph 19

- Paragraph 19 requires the auditor to obtain an understanding of various matters related to the company's selection and application of accounting principles, including "the financial reporting competencies of personnel involved in selecting and applying significant new or complex accounting principles." We question whether in creating this requirement the Board has considered limitations in the auditor's ability to do this in a first-year audit or when the client has new personnel.

Paragraph 21

- Footnote 12 at paragraph 21 refers to paragraph 13 of AS 5 which discusses scaling the audit. The guidance in paragraph 13 is equally relevant to the auditor performing an audit only of the financial statements and should be included in this proposed standard.

Paragraph 32

- Paragraph 32 unnecessarily duplicates guidance in AS 5 regarding the period-end financial reporting process. We believe the guidance in paragraph 32 is equally relevant to an audit

only of financial statements as it is to an integrated audit. We recommend that the Board replace the second sentence (including the bullet points) of paragraph 26 in AS 5 with a cross reference to paragraph 32. Also, we recommend deleting the Note to paragraph 32 and adding the following as the last sentence: "Paragraphs 26-27 of Auditing Standard No. 5 include guidance on evaluating the period-end financial reporting process in an integrated audit."

Paragraph 40

- A requirement in existing PCAOB standards that the auditor "should consider" whether information from the results of interim reviews is relevant when identifying risks of material misstatement in the year-end audit has been changed to a requirement that the auditor "should evaluate" that information. We believe "should consider" provides appropriate direction. If not restored, the PCAOB should clarify whether the auditor's response and level of documentation are expected to change under the proposed standard.

Paragraph 41

- A requirement in paragraph 8 of ISA 315 that the engagement partner "should consider" whether information obtained from other engagements performed by the engagement partner for the entity is relevant to identifying risks of material misstatement has been changed to a requirement that the auditor "should assess" that information. We believe "should consider" provides appropriate direction. If not adopted, the PCAOB should clarify whether the auditor's response and level of documentation are expected to differ under the proposed standard.
- We recommend narrowing the scope of paragraph 41 to "other engagements performed by the **engagement partner auditor**," consistent with ISA 315 paragraph 8. Particularly on large global audits, it is not practical to expect the auditor to assess information obtained on all engagements performed by the audit firm for the client.

Paragraph 52b

- We are unclear as to the difference between the auditor's inquiries regarding the audit committee's views about the risks of fraud as included in paragraph 52(b)(1) and those included in paragraph 52(b)(4), and suggest that additional clarification be provided.

Paragraph 52d

- We believe the requirement for the auditor to make specific inquiries about fraud of "accounting and financial reporting personnel, including, in particular, employees involved in initiating, authorizing, processing, or recording complex or unusual transactions" is unnecessarily prescriptive, and may result in an extensive volume of inquiries. We suggest that the proposed standards retain the auditor's ability to apply judgment in determining those with whom such discussions are appropriate, which is more consistent with the current guidance in AU 316.25 and paragraph A16 of ISA 240.

Paragraph 54

- PCAOB paragraph 54 requires that the auditor "should assess who might reasonably be expected to have information that is important to the identification and assessment of fraud

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risks," which has been changed from the requirement in extant AU 316.24 that "the auditor should use professional judgment to determine those others within the entity to whom inquiries [about the existence or suspicion of fraud] should be directed and the extent of such inquiries. In making this determination, the auditor should consider whether others within the entity may be able to provide information that will be helpful to the auditor in identifying risks of material misstatement due to fraud..."

We believe that the requirement in paragraph 54, which follows requirements to make specific inquiries about fraud of management (52a), the audit committee or its chair (52b), internal audit (52c), and accounting and financial reporting personnel, including, in particular employees involved in initiating, authorizing, processing, or recording complex or unusual transactions (52d), inappropriately suggests that the others to whom inquiries should be directed is susceptible to an objective assessment based on what "might reasonably be expected" (i.e., if hindsight reveals that the auditor didn't identify the "right" person to whom to direct such inquiries, the auditor's assessment was deficient).

Paragraph 56

- The Note to the 5th bullet point in this paragraph refers the reader to paragraphs 28-33 of AS 5 for additional discussion of identifying significant accounts and disclosures and their relevant assertions. We recommend incorporating 28-33 in this proposed standard and replacing it in AS 5 with a cross reference to this standard.

Paragraph 57

- This paragraph refers the auditor performing an audit of internal control over financial reporting to paragraph 34 of AS 5 which sets forth certain objectives that the auditor should achieve to further understand the likely sources of potential misstatement and as part of selecting the controls to test. We believe some of the guidance in paragraphs 34-38 of AS 5 is relevant in an audit only of financial statements and would be particularly helpful when the auditor intends to rely on controls to alter the nature, timing and extent of substantive procedures. We encourage the PCAOB to consider how paragraphs 34-38 of AS 5 may be adapted and incorporated into this proposed standard.

Paragraph 63

- In determining which risks are significant risks, ISA 315.27 includes factors that the auditor "shall consider" whereas the proposed standards includes factors that "should be evaluated." We believe "should consider" provides appropriate direction. If not adopted, the PCAOB should clarify whether the auditor's response and level of documentation are expected to differ under the proposed standard.

Appendix A

- Paragraphs A1 and A4-A6 in the Appendix contain presumptively mandatory responsibilities. We believe that requirements should be limited to the body of standards and should not appear in Appendices.

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

Paragraph 3

- We recommend that the Board adopt the objective in ISA 330, as follows, in order to reinforce the important linkage between assessing risk and audit response:

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

Paragraph 10

- Paragraph 10 is unnecessarily repetitive with paragraph 14 of AS 5. We recommend replacing it with the following:

When planning and performing the audit of internal control over financial reporting ("audit of internal control"), the auditor should refer to paragraphs 14-15 of AS 5 for guidance.

Paragraph 11

- We recommend editing the guidance in paragraph 11 to read "In the audit of the financial statements, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the **identified** fraud risks" to align with the guidance in paragraph 14 of AS 5 that "the auditor should evaluate whether the company's controls sufficiently address *identified* fraud risks...[emphasis added]"

Paragraphs 14-16

- Because these paragraphs are relevant only when the auditor is performing an integrated audit, we suggest they be deleted from the proposed standard and replaced with a reference to AS 5.

Paragraph 19

- This paragraph requires the auditor to perform tests of controls "for each relevant assertion for which substantive procedures alone cannot provide sufficient appropriate audit evidence" but provides no guidance to explain when such circumstances may arise. We recommend that the Board consider including guidance about when this is the case as described on page 6 of our letter.

Paragraphs 21-35

- These paragraphs (except for 29) are incorporated nearly verbatim from paragraphs 42-45 and 49-56 of AS 5. We recommend replacing these paragraphs in AS 5 with a reference to the appropriate guidance in this standard. Also we suggest that the PCAOB consider incorporating into paragraphs 21 and 23 of the proposed standard the guidance on smaller, less complex companies from the Notes to AS 5 paragraphs 42 and 44.

Paragraph 37

- Paragraph 37 provides guidance about the factors the auditor should consider to determine the evidence needed in the current year audit to support the auditor's control risk assessment. The factors listed include those in paragraph 58 of AS 5; however, unlike paragraph 58, which incorporates the factors identified in paragraph 47 of AS 5 by reference, paragraph 37 includes some of the factors from paragraph 47 but seems to exclude other relevant risk factors from paragraph 47 (e.g., the nature and materiality of the misstatements that the control is intended to prevent or detect and the degree to which the control relies on the effectiveness of other controls). We recommend incorporating paragraphs 46 and 47 of AS 5 in this proposed standard under the subhead "Relationship of Risk to the Evidence to be Obtained," and then aligning paragraph 37 more closely with paragraph 58 in AS 5.

Paragraph 41

- We recommend that the last sentence of the Note to paragraph 41 be modified as follows:

"Also, when performing a dual-purpose test, the auditor should evaluate the results of the test in forming conclusions about both the assertion and the ~~effectiveness~~ control **being tested**."

Paragraphs 47-50

- We suggest replacing the phrase "at interim dates" or "at an interim date" with the phrase "as of an interim date" in these paragraphs.

Appendix 5: Evaluating Audit Results

Paragraph 3(a)

- If the PCAOB retains the definition of error in paragraph 3(a), we recommend adding a footnote reference to footnote 3 in Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*, which explains that the term "error," as used by the FASB, is equivalent to the definition of "misstatement" in the auditing literature.

Paragraph 3(b)

- The term "misstatement" is not defined. The proposed definition appears to instead be a definition of a "material misstatement." We recommend defining these terms separately and as follows:

Misstatement - A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that should have been reported in accordance with the applicable financial reporting framework. Misstatements can result from error or fraud.

Material Misstatement - A misstatement that, individually or in combination with other misstatements, causes the financial statements not to be

presented fairly, in all material respects, in conformity with the applicable financial reporting framework.

Paragraph 4

- A requirement in paragraph 27 of ISA 330 that the auditor "should consider" all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements, has been changed to a requirement that the auditor "should evaluate" that evidence. We believe "should consider" provides appropriate direction. If not adopted, the PCAOB should clarify whether the auditor's response and level of documentation are expected to differ under the proposed standard.

Paragraph 13

- We believe that the proposed standard would be strengthened by incorporating the application guidance that has been omitted from paragraph A2 of ISA 450 which clarifies that "clearly trivial" is not another expression for "not material."

Paragraph 15

- We suggest modifying the phrase at the end of the sentence as follows: "... when taken with the aggregate of misstatements accumulated during the audit **that remain uncorrected**,"

Paragraph 16

- We recommend strengthening paragraph 16 by incorporating the requirement in ISA 450 paragraph 8 that the auditor should request that management correct the misstatements communicated.

Paragraph 19

- This paragraph uses the words "detected in prior years" instead of "related to the prior year" as used in ISA 450, paragraph 11. We believe this changes the meaning since there may be misstatements detected in the current year and related to the prior year, which would be encompassed in the ISA language, but not the PCAOB language.

Paragraph 25

- The guidance requires that the auditor "should assess" the qualitative aspects of the company's accounting practices when evaluating whether the financial statements as a whole are free of material misstatement, whereas paragraph 12 of ISA 700 states that the auditor's evaluation "should include consideration" of the qualitative aspects of the entity's accounting practices. We believe "should consider" provides appropriate direction. If not adopted, the PCAOB should clarify whether the auditor's response and level of documentation are expected to differ under the proposed standard.

Paragraphs 30 and 32

- We believe the requirement in paragraph 32 that the auditor's assessment of fraud risks should be ongoing throughout the audit would be more appropriately placed in Appendix 3, *Identifying and Assessing the Risks of Material Misstatement*, perhaps following paragraph 61, along with a footnote reference to paragraph 30 of this proposed standard. We also suggest replacing the phrase "earlier in the audit" in paragraph 30 with the phrase "throughout the audit." Finally, we recommend moving Appendix A, "Matters That Might Affect the Assessment of Fraud Risks," to Appendix 3.

Paragraphs 39-40

- The guidance in these paragraphs should be simplified to state that the auditor performing an integrated audit should determine how the results of tests of controls performed in the audit of internal control over financial reporting, including any identified control deficiencies, affect the appropriateness of risk assessments and the nature, timing, and extent of substantive procedures in the audit of the financial statements.

Paragraphs 41-44

- The guidance under the heading "Evaluating the Results of the Audit of Internal Control Over Financial Reporting" is not relevant to the auditor performing an audit only of financial statements. We therefore recommend replacing these paragraphs with a reference to the appropriate guidance in AS 5.

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

Paragraph 6

- Paragraph 6 repeats a requirement from paragraph 20 of AS 5 that the auditor "shall use the same materiality considerations he or she uses in the audit of the company's annual financial statements." The placement of this paragraph in the subsection "Materiality for the Financial Statements as a Whole" could be interpreted to mean that it is not relevant, for example, in the subsection "Materiality for Particular Accounts or Disclosures." We recommend including this guidance in the Introduction in paragraph 1.

Paragraphs 8 and 9

- Paragraphs 8 and 9 require the auditor to determine the amount of "tolerable misstatement." ISA 320, paragraph 12, uses the term "performance materiality" for essentially the same concept, as does the ASB's proposed auditing standard *Materiality in Planning and Performing an Audit*. Since these terms seem to have the same meaning, we recommend the PCAOB replace the term "tolerable misstatement" with "performance materiality" to avoid confusion.

Paragraph 9

- A requirement in existing PCAOB AU 312.23 that the auditor "should consider" the nature, cause (if known), and amount of misstatements that were accumulated in audits of the financial statements of prior periods has been changed in this paragraph to a requirement

that the auditor "should take into account" that information. We believe "should consider" provides appropriate direction. If not restored, the PCAOB should clarify whether the auditor's response and level of documentation are expected to change under the proposed standard.

Appendix 7: Audit Evidence

Overall

The proposed standard is silent on use of evidence from previous audits. ISA 500 application material (paragraphs A1, A11, and A26) acknowledges that information from previous audits may be included in audit evidence. The PCAOB should acknowledge that information obtained in previous audits may be used as possible audit evidence.

Paragraph 2

- We recommend that the PCAOB adopt a consistent approach to defining terms. We believe that the guidance in paragraph 2 is intended to be a definition and, as such, that it should be included in a Definitions section of the standard (consistent with the approach taken in Appendix 3 and Appendix 5).

Paragraph 3

- While we do not disagree with the objective stated in paragraph 3, it seems overly broad in the context of the guidance in the proposed standard. We recommend conforming to the ISA 500 objective, which focuses on designing and performing audit procedures in order to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

Paragraph 4

- Consistent with our comment on paragraph 3, the requirement in paragraph 4 should be replaced with that in paragraph 6 of ISA 500 to better focus on the auditor's requirement to design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence.

Paragraph 27

- We recommend that the PCAOB incorporate guidance in this paragraph acknowledging that "selective examination of specific items, particularly if those items are selected based on the auditor's belief that they are more likely to contain a misstatement, may provide the auditor with some audit evidence concerning the remainder of the population" from paragraph A26 of the ASB's proposed auditing standard, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

Paragraph 29

- A requirement in paragraph 11 of ISA 500 that the auditor "should consider" the effect of inconsistent evidence on other aspects of the audit has been changed in this paragraph to a requirement that the auditor "should assess" the effect. We believe "should consider"

provides appropriate direction. If not adopted, the PCAOB should clarify whether the auditor's response and level of documentation are expected to differ under the proposed standard.

Appendix 8: Proposed Conforming Amendments to PCAOB Standards

Overall

We recommend marking proposed conforming amendments from the text of extant standards to clarify how the proposed changes are intended to change audit practice and to improve the transparency of the Board's standard-setting process. This would be particularly helpful to commenters when the Board is proposing extensive changes to its interim standards as, for example, in the case of AU 316 *Consideration of Fraud in a Financial Statement Audit* and AU 350 *Audit Sampling*.

We agree with the Board's proposed replacement of "competent" with "appropriate" in describing audit evidence throughout the PCAOB standards. We also recommend that the term "evidential matter" be replaced with "audit evidence" throughout the PCAOB standards to be consistent with the Board's proposed risk assessment standard *Audit Evidence*.

AU sec. 350, "Audit Sampling"

Conforming change (n) to replace paragraph AU 350.23

- The PCAOB proposes to replace a requirement in the first sentence of extant AU 350.23 that the auditor "should consider" various factors in determining the number of items to be selected in a sample for a particular substantive tests of details with a requirement that the auditor "should take into account" these factors. We believe "should consider" provides appropriate direction. If not restored, the PCAOB should clarify whether the auditor's response and level of documentation are expected to change under the proposed standard.
- We believe the phrase "size and frequency of" preceding "misstatements" is unnecessarily prescriptive and we recommend deleting it.
- The role of professional judgment is critical in determining sample size when nonstatistical sampling is used. That should be acknowledged in this paragraph, consistent with existing PCAOB guidance and with the guidance in paragraph A11-A12 of ISA 530 (Redrafted) *Audit Sampling* and paragraph A15 of the ASB's proposed standard *Audit Sampling* (Redrafted). We observe that the PCAOB has not deleted numerous other references to professional judgment in extant AU 350.
- We recommend moving the last sentence of paragraph 23A, edited as proposed below in our comment on conforming changes (o) and (s), to become the last sentence of paragraph 23 because it is a natural extension of the guidance proposed in the bullet above.

Following are the changes recommended above marked from paragraph 23 as it is proposed to be changed by PCAOB conforming change (o):

.23 To determine the number of items to be selected in a sample for a particular substantive test of details, the auditor should **consider** ~~take into account~~ the tolerable misstatement; the allowable risk of incorrect acceptance (based on the assessments of inherent risk, control risk, and the detection risk related to the substantive analytical procedures or other relevant substantive tests); and the characteristics of the population, including the expected size and frequency of misstatements. **An auditor who applies nonstatistical sampling uses professional judgment to relate these factors in determining the appropriate sample size. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to the sample size resulting from an efficient and effectively designed statistical sample.**

Conforming change (p) to replace the last sentence of paragraph AU 350.25

- The PCAOB proposes to replace a requirement in the last sentence of AU 350.25 that the auditor "should consider" whether reasons for the auditor's inability to examine the items have other implications for the audit with a requirement that the auditor "should evaluate" such reasons. We believe "should consider" provides appropriate direction. If not restored, the PCAOB should clarify whether the auditor's response and level of documentation are expected to change under the proposed standard.
- We recommend the PCAOB restore guidance deleted from extant AU 350.25 by adding the phrase "and the planned assessed level of control risk" after the phrase "particularly the assessment of the risk of material misstatement due to fraud." We believe this guidance is useful to practitioners.

Conforming changes (o) and (s) to add language to paragraphs AU 350.23A and .38

- We believe the PCAOB's proposed language implies that auditors are required to calculate sample sizes using both statistical and non-statistical approaches, in all circumstances, in order to compare the sample sizes. We suggest that the PCAOB remove the phrase "or larger than" from the last sentence of the proposed guidance in both paragraph 23A and paragraph 38, and add footnote 5 to the AICPA's AU 350.23, which states "This guidance does not suggest that the auditor using nonstatistical sampling compute a corresponding sample size using statistical theory" to clarify the intent.
- We also recommend adding language to the last sentence in paragraph 38 to acknowledge that nonstatistical sampling approaches will not result in sample sizes that are comparable to those determined by statistical sampling approaches applied to certain populations.

Following are the changes recommended above marked from paragraphs 23A and 38 as they are proposed to be changed by PCAOB conforming changes (o) and (s):

.23A Table 1 of the Appendix describes the effects of the factors discussed in the preceding paragraph on sample sizes in a statistical or nonstatistical sampling approach. When circumstances are similar, the effect on sample size of those factors should be similar regardless of

whether a statistical or nonstatistical approach is used. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, ~~or larger than,~~ the sample size resulting from an efficient and effectively designed statistical sample.^x

^x ***This guidance does not suggest that the auditor using nonstatistical sampling compute a corresponding sample size using statistical theory.***

.38 To determine the number of items to be selected for a particular sample for a test of controls, the auditor should consider the tolerable rate of deviation from the controls being tested, the likely rate of deviations, and the allowable risk of assessing control risk too low. An auditor applies professional judgment to relate these factors in determining the appropriate sample size. When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or nonstatistical approach is used. Thus, when a nonstatistical sampling approach is applied properly ***to populations other than small populations and populations with infrequently operating controls***, the resulting sample size ordinarily will be comparable to, ~~or larger than,~~ the sample size resulting from an efficient and effectively designed statistical sample.^{xx}

^{xx} ***See footnote x.***