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COMMENTARY

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

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INTRODUCTION

The Auditing Standards Committee of the Auditing Section of the American Accounting Association is pleased to provide comments on the *PCAOB Rulemaking Docket Matter No. 026: Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Conforming Amendments to PCAOB Standards*. (Please see http://www.pcaobus.org/Rules/Docket_026/2008-10-21_Release_No_2008-006.pdf for the full text of PCAOB Release No. 2008–006.) We very much appreciate the opportunity to provide input.

The views expressed below are those of the members of the Auditing Standards Committee and do not reflect an official position of the American Accounting Association. In addition, the comments reflect the overall consensus view of the Committee, not necessarily the views of every individual member. We hope that the following comments and suggestions are helpful and will assist in finalizing the proposed guidance.

GENERAL COMMENTS

The Committee commends the PCAOB ("the Board") for generally maintaining consistency with International Standards on Auditing (ISAs) in developing these risk assessment standards. We believe that convergence with international standards is desirable. It would be preferable to have one set of primary standards based on ISAs, with PCAOB auditing standards for requirements unique to U.S. registered securities. Until this level of convergence is possible, the approach taken in these standards appears to be the best option. The Committee also believes that the focus on the iterative nature of the audit and the continued recognition of differences in approach that depend on the size and complexity of the client and the engagement are positive

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features of these standards. In addition, given the scope and focus of the proposed standards, we believe that these standards do indeed provide an improved foundation for future standard setting, as the Board intended.

The Committee believes that the proposed standards appropriately address the risk of fraud. Important concerns and requirements about fraud are integrated into the proposed standards and overall theme of assessing the risk of material misstatement, whether due to error or fraud. The Board indicates that practice inspections revealed a tendency for auditors to view the consideration of the risk of fraud as separate from the rest of the audit. However, in integrating fraud risk assessments into the overall risk assessment process, it is important to retain the emphasis in the interim standards that the auditor appropriately identify and respond to the risk of fraud. In appropriately integrating fraud guidance into the proposed risk assessment standards, the Board has chosen to re-emphasize certain aspects of interim standard AU Sec. No. 316, such as the engagement team meeting to discuss fraud, and the requirement to consider fraud risk for revenue recognition. However, this approach may detract from the overall clarity of the standards and be confusing to those in practice. The Board should consider fully integrating fraud assessment with the new risk assessment standards by bringing forward all concepts they consider relevant from interim standard AU Sec. No. 316.

The following section presents a number of specific comments or suggestions relating to the proposed standards, organized along the lines of the questions posed by the Board in Appendix 9 of the proposed standards.

SPECIFIC COMMENTS ADDRESSING PCAOB-PROPOSED QUESTIONS[1]

Proposed Auditing Standard: *Audit Risk in an Audit of Financial Statements*

(1) Does the proposed standard appropriately describe audit risk and its component risks?

The proposed standard maintains familiar terminology that appropriately describes audit risk. However, we believe that this description could be enhanced in several regards.

Paragraph 6 (Page A1–3) of the proposed standard refers to risk of material misstatement at the overall financial statement level. We believe that this statement is confusing since inherent risk as described in Paragraph 7a (Page A1–3) is at the assertion level. We prefer that the financial statement level risks be referred to as pervasive risks that may affect many accounts and assertions, and account-specific risks be defined as those that may affect one or more specific assertions in an account or class of transactions.

It may be appropriate to reference the proposed standard on *Identifying and Assessing Risks of Material Misstatement* to note that these risks are identified by performing risk assessment procedures, including identifying client business risks and other factors that may give rise to these risks.

Research suggests that auditors respond more to risks that increase income and assets (Abbott et al. 2004; Houston et al. 1999). It may be helpful to note in Paragraph 5 (Page A1–3) that material misstatements can arise from both understatements and overstatements of assets and income.

1 The PCAOB Release presented 26 separate questions. This comment letter includes responses to 12 of those questions; the Auditing Standards Committee did not have substantive comments on the other questions.

Proposed Auditing Standard: *Audit Planning and Supervision*

(3) Is the direction regarding multi-location engagements reasonable and appropriate?

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

In general, the Committee believes that the direction regarding multi-location audits is appropriate. We believe that additional guidance could be helpful in addressing materiality for multi-location audits, as well as unpredictability of audit procedures. In Paragraph 11b, when evaluating the materiality of the location or business unit, it is critical that the auditor consider the materiality of all units not tested in the aggregate. We note that the interim standard on fraud required the auditor to incorporate unpredictability in testing, including "performing procedures at different locations or at locations on an unannounced basis." Unpredictability is addressed in Paragraph 4c (Page A4–2) of proposed standard *The Auditor's Responses to the Risks of Material Misstatement*, but does not include this terminology related to other multi-location engagements. It is important that client management and personnel are not led to believe that any locations or units will be exempt from testing.

Although not directly related to any of the questions posed in Appendix 9, we believe that the discussion in Paragraph 13 (Page A2–6) should be expanded to discuss the role of other types of specialists and how they might be used in the audit, consistent with the discussion on Page A9–3.

Proposed Auditing Standard: *Identifying and Assessing Risks of Material Misstatement*

(7) Are the additional procedures in Paragraph 13 that the auditor should consider performing when obtaining an understanding of the company and its environment reasonable and appropriate for audits of issuers? Should these procedures be specifically required for all audits, or is the responsibility to consider performing the procedures sufficient?

The Committee believes that the procedures are appropriate. The Committee also believes that the responsibility to consider performing the procedures is sufficient, although some Committee members expressed the belief that they should be specifically required.

(8) Is the new requirement to assess certain matters related to the control environment component of internal control over financial reporting reasonable and appropriate? Is the difference between the required performance for an audit of internal control over financial reporting and an audit of financial statements only clear?

The committee believes that the requirement is reasonable and appropriate. However, we do not find the distinction between the required performance for an audit of internal control over financial reporting and an audit of financial statements only to be clear. The requirements of the proposed standards are directed at audits of financial statements. Frequent notes that procedures may be performed in conjunction with the audit of internal control seem unnecessary—a single note would suffice. The note on Page A1–2 establishes that consideration of risk in an audit of internal control over financial reporting is addressed in Auditing Standard No. 5.

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

We believe that the concept of key engagement team members may require further clarification, as the term "significant engagement responsibilities" is not defined. Further, the proposed standard does not address the role of IT or other specialists in these discussions. It can be implied that audit staff are not included as key engagement team members. However, if these staff will be responsible for auditing areas with identified fraud risks, it would seem helpful to include them in the discussion. The distinction in Paragraph 49 (Page A3–18) of items that should be emphasized to all engagement team members is helpful.

The tone set and participation by the engagement partner is critical to the success of the fraud risk assessment process (Carpenter and Reimers 2009). The "tone at the top" is an element of quality control that should be emphasized here. In addition, 'priming' the audit team discussion through the inclusion of recurring fraud risk factors appears to help in the assessment of fraud risk (Bamber et al. 2008). Although the use of checklists and decision aids may seem contrary to the idea of brainstorming, their use may ensure the completeness of the consideration of fraud risk factors.

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

We believe that the term "significant risk" should be more clearly defined. We agree with the presumption of fraud risk for revenue recognition required in Paragraph 61 (Page A3–23). However, we believe that fraud risk assessments should be linked back to output from the fraud risk brainstorming session. That is, we would clarify how the auditor should document that the presumption of a revenue recognition fraud risk is overcome, and also consider what areas may constitute a greater area of fraud risk given the nature of the entity's business.

(13) Should the proposed standards include specific requirements and direction regarding documentation (e.g., summaries of the identified and assessed risks and the linkage to the auditor's responses)?

We appreciate the desire to not prescribe additional documentation requirements beyond those contained in Auditing Standard No. 3. However, because of the importance of identifying significant risks and the auditor's response to those risks, as well as the repeated findings of observers such as the Panel on Audit Effectiveness ("the PAE") (POB 2000) and academic researchers (e.g., Zimbelman 1997) that have noted the failure of auditors to identify significant risks and link those risks they did identify to specific audit responses, we believe that the proposed standards should include a documentation requirement that the auditor summarize all significant risks, the auditor's response to those risks, and the findings of the procedures.

In the introduction to the proposed standards, the Board notes that the PAE report (POB 2000) indicated that many audits were performed using substantive testing approaches with little or no attention paid to risk assessments. The Board should consider additional guidance to discourage or explicitly discourage a default to maximum risk assessment.

In our comments regarding Question 14, we specifically address the need for additional guidance on the assessment of control risk and performance of tests of controls. The risk of material misstatement is the combination of inherent risk and control risk. Assessment of control risk below maximum generally requires the performance of tests of controls. However, there is no similar requirement for inherent risk. Are the risk assessment procedures suggested in the proposed standards sufficient to support a low assessed level of inherent risk if no specific risks of misstatement are identified? What documentation of the risk assessment procedures is necessary to support a low assessed level of inherent risk at the assertion level?

Additional Comments Related to the Proposed Standard

Special Audit Consideration

We believe that the concept "special audit consideration" in response to the term "significant risk" in Paragraph 4b (Page A3–2) needs further clarification. Does it imply changes in audit procedures or the overall conduct of the audit? We note that all fraud risks are significant risks, and may warrant special consideration, but the response could be in the form of additional testing, rather than changes in procedures or the overall conduct of the audit.

Control Activities

We also note that the proposed standard does not provide any detailed discussion of control activities in Paragraph 34 (Page A3–14). Given their importance to the risk assessment process and the assessment of control risk, some additional discussion of the nature of control activities seems appropriate.

Considering Information from Review Engagements

Paragraph 40 (Page A3–15) directs the auditor to evaluate whether information obtained from reviews of interim financial information is relevant to identifying risks of material misstatement in the year-end audit. The Board should provide additional guidance in this area as research has indicated that fraudulent financial reporting at year-end often begins in an interim period (Beasley et al. 1999).

Nonfinancial Performance Measures

In "Performing Analytical Procedures" (Paragraphs 42–44; Page A3–16), the proposed standard should encourage the use of nonfinancial performance measures because they may be indicators of fraud and may be less vulnerable to manipulation or concealment than financial statement amounts (Brazel et al. 2007).

Presumption of Management Honesty and Integrity

The tone of the wording in Paragraph 48 (Pages A3–17 and A3–18) implies that the auditor should adopt a mindset that assumes that management lacks integrity and is dishonest. Instead the language should direct that the auditor maintain an attitude of professional skepticism that assumes neither integrity nor lack of integrity, honesty nor dishonesty.

Timing of Significant Transactions

Paragraph 63f (Page A3–24) discusses significant transactions that "appear to be unusual due to their size or nature." This phrase might also include the concept of "timing," as the timing of significant transactions (near year-end, for example) could be an indicator of risk.

Proposed Auditing Standard: *The Auditor's Responses to the Risks of Material Misstatement*

(14) Does the proposed standard clearly describe the auditor's responsibilities regarding tests of controls in integrated audits and in audits of financial statements only?

We believe that the proposed standard clearly describes the auditor's responsibilities. However, we note that there has been some confusion about the need to perform tests of controls in an audit of the financial statements only. We interpret the standard to indicate that tests of controls are not required if control risk is assessed at maximum, and sufficient appropriate evidence can be obtained from substantive procedures alone. This is the case even if evaluation of the design and implementation of controls indicates that controls are effective. Also, we believe that clear guidance needs to be provided as to the reliance, if any, that can be placed on controls based on risk assessment procedures related to the design and implementation of controls.

Proposed Auditing Standard: *Evaluating Audit Results*

(18) Are the requirements and direction regarding accumulating identified misstatements and evaluating uncorrected misstatements appropriate and adequate?

Paragraph 19 (Page A5–6) indicates that the auditor should evaluate the effects of uncorrected misstatements detected in prior years on the accounts and disclosures, and the financial statements as a whole, but does not prescribe how they should be considered. In the past, firms have either followed the so-called "iron curtain" approach in which all cumulative uncorrected misstatements are deemed to affect the current period income statement, while others followed the "rollover" approach that quantifies a misstatement based on the amount of the misstatement originating in the current year and ignores the effects of prior year misstatements (POB 2000). Staff Accounting Bulletin No. 108 (SEC 2006) requires registrants to use a dual approach in considering the potential effects of uncorrected misstatements. It may be helpful to add a footnote describing these two approaches.

Proposed Auditing Standard: *Consideration of Materiality in Planning and Performing an Audit*

The Committee believes that the requirements are aligned with the concept of materiality as described in the courts' interpretation of the federal securities laws. We believe that the standard could expand the discussion of qualitative aspects of materiality, although the PCAOB may prefer to rely on SEC Staff Accounting Bulletin No. 99 (SEC 1999) and other sources for guidance in this regard.

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

We believe that the term tolerable misstatement is appropriate and clear with regard to AU Sec. No. 350, but the proposed standard would be clearer if tolerable misstatement were redefined in the standard. We believe that there is the possibility of confusion about materiality for specific accounts and tolerable misstatement, and a footnote or clarifying language could help distinguish between these two concepts.

Proposed Auditing Standard: *Audit Evidence*

The Committee believes that the principles for evaluating the sufficiency, relevance, and reliability of evidence are clear and we agree with the alignment in terminology with the ISAs. The guidance on authentication should help auditors evaluate and respond to the possibility that documents may not be authentic.

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

The retention of the five categories of assertions in AU Sec. No. 326 is one case where the proposed standards differ significantly from the 13 assertions in the ISAs. The proposed standard allows for the use of other assertions, but the inconsistency adds complexity and confusion about the assertions. We do not necessarily believe that the 13 assertions in the ISAs are the most appropriate. However, we believe that the proposed standard could improve and expand on the five assertions in AU Sec. No. 326 and provide greater consistency with the ISA assertions.

The assertions for existence or occurrence and completeness already indicate that they apply to transactions and accounts. Providing for a core set of assertions and noting that they apply to three categories—classes of transactions, account balances, and presentation and disclosure—would more closely align the assertions with the ISA assertions. This would also highlight the differences in these assertions when applied to classes of transactions, account balances, and presentation and disclosure. Such an approach would provide greater emphasis on presentation and disclosure.

We believe that additional assertions for net realizable and/or fair value as well as cutoff should be considered. Net realizable value and fair value are encompassed in the valuation or allocation assertion. However, the auditing importance of these issues might merit a separate assertion, and we note that several large CPA firms apply separate assertions or audit objectives for the accuracy and realizable value components of valuation.

Our suggested assertion for cutoff goes beyond the concept of examining whether transactions at or near year-end are recorded in the proper period and would encompass the period-end financial reporting process as discussed in Paragraph 32 on Page A3–13.

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