COMMENTARY

Auditing Standards Committee
Comment Letter

PCAOB Rulemaking Docket Matter No. 026: Re-Proposed Auditing Standards Related to the Auditor’s Assessment of and Response to Risk; Proposed Conforming Amendments to PCAOB Standards

Participating Committee Members

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: Re-Proposed Auditing Standards Related to the Auditor’s Assessment of and Response to Risk; Proposed Conforming Amendments to PCAOB Standards.1 We very much appreciate the opportunity to provide input.

The views expressed in this letter and attachments 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 our comments and suggestions are helpful and will assist in finalizing the proposed guidance. If the Board has any questions about our input, please feel free to contact our committee chair for additional follow-up.

GENERAL COMMENTS

The Committee encourages the PCAOB (“the Board”) to maintain consistency with International Standards on Auditing (ISAs) when developing new standards. We suggest that the Board use existing standards (AUs and ISAs) as the baseline and then make adjustments as necessary for public company audits. This would allow the Board to leverage the work of the ISA and Auditing Standards Board (ASB) and reduce any unnecessary differences between the standards.

1 The proposed standard is available at: http://pcaobus.org/Rules/Rulemaking/Pages/Docket026.aspx.

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(Glover et al. 2009). For example, the clarified ASB standards (AUs) start with ISAs and then make changes for the United States based on the expertise of ASB members, which enhances convergence between the AUs and ISAs. Similarly, the Board could use AUs as its basis for standards. We believe that it would be preferable to have one set of primary standards (based on ISAs and AUs), with PCAOB auditing standards addressing requirements unique to U.S. registered securities when necessary. With these standards, the Board is moving toward the development of comprehensive standards that largely overlap with other auditing standards.

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.

**COMMENTS ADDRESSING PCAOB-PROPOSED QUESTIONS**

**Proposed Auditing Standard: Audit Risk**

Does the new proposed standard on audit risk describe clearly the concept of audit risk and its components?

The revised standards consistently use the label “risk” when referring both to auditor judgment about the likelihood for material misstatement and the actual likelihood of material misstatement. Those two constructs are very different. Using the terms interchangeably in an auditing standard could cause expectations gaps. The generally accepted interpretation of the term “risk” is probability or likelihood. Because auditors never know the actual likelihood, they never really respond to risk as the public understands risk. Auditors’ assessments of and responses to risk actually refer to their informed opinions (or assessments) about the likelihood for material misstatement and the decisions (or responses) motivated by those opinions. Auditors respond to evidence under ambiguous conditions; that is, conditions characterized by second-order uncertainty. They are never in a position to respond to risk by evaluating evidence when they know the actual probability that misstatements exist. Perhaps the Board should consider defining these terms separately.

Paragraph 8 (p. A1-3) states that “Inherent risk and control risk are the company’s risk; they exist independently of the audit.” This wording can cause confusion regarding the importance of inherent risk and control risk on the auditor’s actions. It would be better to emphasize that inherent risk and control risk are a function of the company’s characteristics, but influence the auditor’s actions. It would be helpful to emphasize that the auditor assesses these risks using risk assessment procedures and then designs testing to be responsive to those risks. In addition, while the assumption that inherent risk is independent of the audit has been commonly held over time, the statement that control risk is independent of the audit implies that the cost-benefit decision (audit/test controls [i.e., cost] to reduce control risk [i.e., benefit]) that is present in private company audits is not an option for public company audits (i.e., in private company audits control risk is typically not independent of the audit). The standards suggest that, for public companies, the auditor is required to test controls (for all material cycles) until control risk can be set at a minimum or “low” level, or until it is determined that a significant deficiency or material weakness should be reported. While this statement is appropriate for large public company audits, the standards should highlight this difference from the audits of small public or privately held entities.

Throughout the standards, the phrase “misstatement...that could be material, individually or in combination with other misstatements” (emphasis added) is used. Clearly, any misstatement could be material “in combination with other misstatements.” This phrase apparently refers to the idea of tolerable misstatement. The standards should clarify the link to tolerable misstatements. Also, the standards provide guidance as to how tolerable misstatement is determined, but they
should explain how auditors incorporate the concept in risk assessment. For example, is the amount different for different accounts, assertions, or disclosures?

There is surprisingly little discussion of going concern risk. The standards appropriately mention the entity’s going concern as an important disclosure and refer to AU Section No. 341, “The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern” (AICPA 1988). However, AU Section No. 341 does not direct auditors to specifically accumulate information about the entity’s going concern status in the planning stage. Many of the procedures required in these standards would provide important information about whether the entity can continue as a going concern. The standards should specifically include gathering information about the entity’s ability to continue as a going concern as part of the risk assessment procedures.

The report of the risk assessment team of the PCAOB research synthesis program recommends using risk assessment measures from other fields such as systems dynamics, data envelopment analysis, etc. to evaluate potential risks (Allen et al. 2006). The Board should consider recommending or mentioning such procedures for auditors. The research synthesis team also points out that fraud risk assessments are enhanced by considering fraud risks separately from the risk of misstatements due to error, which also might be suggested specifically in the standards. Round numbers (e.g., $10,000) or numbers slightly below a threshold (e.g., $9,999) are other important indicators of fraud that could be included in Appendix C of “Evaluating Audit Results.”

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

Are the provisions in the new proposed standard regarding consideration of materiality in multilocation engagements appropriate in light of the auditor’s responsibility to plan and perform audit procedures to detect misstatements that, individually or in combination, would result in material misstatement of the financial statements?

We agree that materiality at an individual location or component cannot exceed, and generally should be less than, materiality for the financial statements as a whole. We suggest that the Board consider providing additional guidance in the area of multilocation or group engagements. PCAOB inspections have noted a wide variety of practices in the area of materiality in multilocation or group audits. Some of the practices have been troubling. For example, some group engagement teams have allocated the full materiality for the financial statements taken as a whole to all components, even when there are a large number of components. Such an allocation methodology can result in an unacceptable level of audit risk at the group level (see Glover et al. 2009). To partially address this troublesome practice, the proposed standard could include simple directional guidance (e.g., as the number of locations or business units increases, the size of unit materiality generally decreases in proportion to materiality for the financial statements taken as a whole). For other examples of additional guidance, see ISA No. 600.21-23, A42-A46 (IFAC 2009), and Glover et al. (2009). For example, ISA No. 600.21 clarifies that the unit or component materiality is established by the group engagement team. This clarity is important to adequately address audit risk at the group level. ISA No. 600.23 discusses statutory audits at the component level (e.g., component materiality for a publicly traded subsidiary). ISA No. 600, Paragraph A43 clarifies that different component materiality may be established for different components and that component materiality need not be an arithmetical portion of financial statement materiality. Importantly, ISA No. 600, Paragraph A43 clarifies that the aggregate of component materiality may exceed the materiality for the group financial statements as a whole. This notion that the aggregation of component materiality can be greater than financial statement materiality is similar in concept to the concern raised below regarding tolerable misstatement in the proposed standard.

In the section on tolerable misstatement, we believe that there is the potential for confusion.
The proposed standard, “Consideration of Materiality in Planning and Performing an Audit” uses the terms “amount” and “amounts” of tolerable misstatement. Does “amounts” relate to classes of transactions (see Note 2 in Appendix 3) or is it the plural form of amount and thus refers to the aggregate of all the tolerable misstatements? If it is the plural, a reader could inappropriately interpret “amounts of tolerable misstatement should be less than materiality level” as a requirement that the summation or aggregation of the individual tolerable misstatements cannot exceed materiality for the financial statements taken as a whole (a similar inappropriate interpretation could be made from PCAOB Interim Standard AU Section No. 350.18 [AICPA 1983] “combined for the entire audit”). We do not believe the use of the term “amounts” is useful or necessary in the proposed standard. Furthermore, it is not conceptually correct, or consistent with current practice in the United States or internationally, to cap the summation or aggregation of the individual tolerable misstatements to financial statement materiality. For further discussion on the determination and allocation of tolerable misstatement see Zuber et al. (1983) and the AICPA 2008 Audit Sampling Guide (AICPA 1988). Capping the aggregation of tolerable misstatements to financial statement materiality could result in over-auditing.

Are the revised provisions regarding reassessment of materiality appropriate in light of the auditor’s responsibility to plan and perform audit procedures to detect misstatements that, individually or in combination, would result in material misstatement of the financial statements?

Similar to having different materiality for particular accounts and disclosures, the standards should discuss the propriety of having different quantitative materiality levels for different evaluations. For example, a larger materiality amount is likely used to evaluate misstatements that have no effect on net income (see AICPA 2008, Audit Sampling Guide). Auditors also likely use a larger materiality amount for applying a misstatement to prior periods under SAB No. 108 (SEC 2006). The propriety of using different materiality measures in these instances should be addressed. The standards should also clarify how having lower materiality for particular accounts and disclosures (e.g., related party transactions) is different from tolerable misstatement.

**Proposed Audit Standard: Identifying and Assessing the Risks of Material Misstatement**

Does the new proposed standard adequately describe the auditor’s responsibilities for performing risk assessment procedures that are sufficient to provide a reasonable basis for the identification and assessment of risks of material misstatement due to error or fraud and to design further audit procedures?

The proposed standard makes clear the auditor’s responsibilities for performing risk assessment procedures. The wording in Paragraph 5 is helpful in that it notes that risk assessment procedures require gathering evidence. This wording helps auditors understand the importance of the risk assessment procedures and that they should be considered to be as important as tests of controls and substantive tests.

However, there are two reasons that assessments of fraud risks and business risks may fail to affect the scope of testing. First, the standards are silent as to whether these assessments should be at the engagement, cycle, account, or assertion level. Perhaps the most efficient method would be one assessment for each at the engagement level. Second, the standards provide little or no guidance on how fraud risk and business risk are to be incorporated into the audit risk model. Specific guidance on how business risks should be incorporated in the assessment of inherent risk would be useful. Although the standards address how auditors should respond to the risk of fraud, they do not address whether identified fraud risk should affect assessments of inherent risk.

In addition, the discussion of industry, regulatory, and other external factors in Paragraph 9
should be expanded to provide similar detail as the other categories of risk factors. For example, it should include a discussion of tax policies, international customs and regulations, etc. Moreover, the discussion of performance measures in Paragraph 17 should be expanded to include incentives that the performance measures may provide for management to misstate the financial statements. The discussion on Page A9, Paragraph 31 might be helpful in this regard.

In the third bullet point in Paragraph 49, consider adding “of internal controls” to “management override.” In the discussion of potential responses (fourth bullet point), research has shown consistently that auditors have difficulty changing the nature of tests in response to variations in fraud risk (Zimbelman 1997; Glover et al. 2003; Asare and Wright 2004). This may be an expertise issue and most audits (especially medium to high fraud risk audits) would benefit greatly from a fraud specialist assisting in this area. Thus, the fourth bullet point should stress that consideration should be given to using a fraud specialist. The fraud brainstorming requirement and potential need to include a forensic specialist should be cross-referenced in the standard Audit Planning and Supervision.

The requirement to understand communications on Page A4-13 in Paragraph 32 should include understanding how management communicates to employees involved in the financial reporting process. Paragraph 53c(3) on Page A4-21 should include inquiring about the results of internal auditors’ procedures, and Paragraph B4 on Page A4-32 should refer to AU Section No. 324 “Service Organizations” (AICPA 1993). Finally, there should be some discussion of planning procedures to audit beginning balances where a previous audit has not occurred.

**Are the auditor’s responsibilities regarding the additional procedures for understanding the company and its environment in Paragraph 11 clear?**

The requirement to understand communications on Page A4-13 in Paragraph 32 should include understanding how management communicates to employees involved in the financial reporting process. Paragraph 53c(3) on Page A4-21 should include inquiring about the results of internal auditors’ risk assessments, control documentation, and audit procedures. Also, on Page A4-32, Paragraph B4 should refer to AU Section No. 324, “Service Organizations” (AICPA 1993).

**Are the proposed requirements regarding obtaining an understanding of internal control over financial reporting appropriate in light of the auditor’s responsibilities for identifying and assessing the risks of material misstatement?**

Paragraphs 19 and 20 (Pages A4-8 and A4-9) discuss how auditors should test the design effectiveness of internal controls. The Board should consider replacing “test” with “evaluate.” Auditors pass judgment on the design effectiveness of internal controls by learning what controls are in place and then evaluating whether those procedures accomplish all of the control objectives that should be in place. Auditors test control effectiveness by gathering evidence that the control is working as it was intended to work. Auditing standards use “test” when referring to a procedure for gathering evidence that something was done correctly. Evaluating design effectiveness simply involves learning how controls are supposed to work and then forming an opinion about whether the suite of controls provides sufficient protection. Auditors do not need any evidence about whether the process was executed correctly. Using the term “test” with respect to forming an opinion about both design and operational effectiveness suggests that these two activities are similar in ways in which they are not.

In addition, the discussion of industry, regulatory, and other external factors in Paragraph 9 should be expanded to provide similar detail as the other categories of risk factors. For example, it should include a discussion of tax policies, international customs and regulations, etc. Moreover, the discussion of performance measures in Paragraph 17 should be expanded to include incen-
tives that the performance measures may provide for management to misstate the financial statements. The discussion on Page A9, Paragraph 31 might be helpful in this regard.

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

Are the proposed requirements for overall responses and responses involving the nature, timing, and extent of audit procedures appropriate given the auditor’s responsibility to opine with reasonable assurance about whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework?

Paragraph 36 states that “The auditor should perform substantive procedures for each relevant assertion of each significant account and disclosure.” The standard should indicate if a significant account is the same as a material account. If so, the standard should use the label “material.” If not, then the standard should define what a “significant account” is. The standard should reference the definition of significant account in PCAOB Auditing Standard No. 5 (AS5) as in Footnote 26 on Page A4-3 (PCAOB 2007).

**Does the new standard clearly describe when tests of controls are necessary in an audit of financial statements only?**

The standard is fairly clear that tests of controls need only be performed in an audit of financial statements if the auditor plans to assess control risk less than the maximum (Paragraph 16), or if substantive procedures alone do not provide sufficient appropriate evidence (Paragraph 17). However, there has been some confusion by practitioners and in academia as to whether choosing not to test controls is an appropriate audit strategy when a substantive approach is deemed more efficient. Further, Paragraph 16 appears to require annual testing of controls and eliminate rotational testing, even for automated controls. Any guidance in AS5 (PCAOB 2007) would not be considered applicable to an audit of the financial statements only. Additional guidance in the standard on this issue would be helpful.

The standard would also seem to indicate that no reduction in control risk should occur based on understanding the design effectiveness of controls. However, a control that does not exist or is designed ineffectively should have a different impact on testing than a control that is designed effectively, but was not tested by the auditor. However, according to the standard, each situation would result in control risk assessed at the maximum.

Paragraph 34(a) should indicate if the Board is referring to compensating controls. Currently, it is unclear which controls are being discussed. Auditors test key controls for each assertion on which they may be able to assess control risk as less than maximum. If those controls are not functioning to the auditor’s satisfaction, what other controls could be tested to support a control risk assessment at less than maximum?

**ADDITIONAL COMMENTS ON THE PCAOB-PROPOSED AUDITING STANDARDS**

**Proposed Audit Standard: Audit Planning and Supervision**

In Paragraph 7, there should be a specific emphasis on preliminary analytical procedures as an integral part of planning, separate from analytical procedures performed as risk assessment procedures. The importance of auditors’ fraud risk assessments, including brainstorming, should also be emphasized as an important part of audit planning. “Matters affecting the industry” should include knowledge of important accounting principles. Paragraph 9 should discuss the need for specialists.

In Paragraph 15, in cases where changes are made during the course of the audit, it would be
prudent to mention that the audit fee or budgeted hours for the engagement should be reassessed to determine if they are adequate, given the change. Otherwise, it is possible that the reassessment will not be done because of budgetary constraints, or that reassessments will lead to under-auditing if the fee or audit time budget are not readdressed.

In Paragraph 23(c), given the percentage of time that engagement management spends in review (because of its importance), it is surprising to observe that only a few paragraphs were devoted to review. Specifically, it might be necessary to provide examples of “levels of supervision” in relation to review. For example, research shows that face-to-face review methods are preferred by reviewers when risks are high, as this review method positively affects the effectiveness of preparers’ work (Brazel et al. 2004; Payne et al. 2010; Agoglia et al. 2010). However, reviewers find electronic review more efficient and choose to use this method when balancing multiple clients. We have learned much about the review process since the issuance of audit review guidance described in AU Section No. 311, “Planning and Supervision” (AICPA 2009). It might be prudent to incorporate this knowledge efficiently into this standard.

Proposed Audit Standard: Sufficient Appropriate Audit Evidence

On Page A7-2, Paragraphs 7 and 8, the definition of quality of evidence as relevant and reliable, although consistent with current standards, is necessary but not sufficient. For example, testing calculations for a complex derivative is both relevant and reliable for the valuation assertion. However, it is not sufficiently persuasive. Another factor is needed in the definition of appropriate evidence. Consider adding language regarding the “diagnosticity” or “persuasiveness” of the evidence.

REFERENCES


