

18 February 2009

Our ref: ICAEW Rep 18/09



THE INSTITUTE  
OF CHARTERED  
ACCOUNTANTS  
IN ENGLAND AND WALES

Office of the Secretary  
PCAOB  
1666 K Street,  
N.W.  
Washington  
D. C. 20006-2803.

cc. Arnold Schilder, Chair, IAASB

By email: *PCAOB Rulemaking Docket No. 026*

Dear Sir

**PCAOB RELEASE NO 2008 - 006: PROPOSED AUDITING STANDARDS  
RELATED TO THE AUDITOR'S ASSESSMENT OF AND RESPONSE TO RISK  
AND CONFORMING AMENDMENTS TO PCAOB STANDARDS**

The Institute of Chartered Accountants in England and Wales (the 'Institute') welcomes the opportunity to comment on the PCAOB's proposed auditing standards on risk assessment and consequential conforming amendments to the PCAOB's standards.

The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 132,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

Our comments have been prepared with the help of our many members working around the world who have detailed knowledge and practical experience of US, EU and other regulatory regimes. We have not sought to answer the PCAOB's specific questions but instead provide main and detailed comments resulting from our discussions. We hope that this approach is of value to the PCAOB.

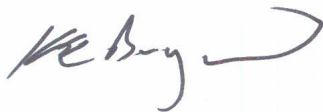
We strongly support the PCAOB's recognition of the importance of the IAASB's standards in the interests of the global convergence and the elimination of unnecessary differences between auditing standards in different jurisdictions. Nevertheless, there is a strong public interest case for the PCAOB to be transparent in its convergence efforts. Genuine convergence is achieved in practice by sacrifice and compromise on the part of all concerned in order to achieve a greater degree of consensus. We are concerned that the proposed standards amount to 'similarity, with add ons', which falls short of convergence and we therefore urge the PCAOB to explain clearly why the approach taken, is necessary or better than a more transparent 'ISA plus' strategy. This is particularly important if the IAASB is to be encouraged to improve its standards in areas where the PCAOB sees weakness.

The UK adopted ISAs in 2005 and we hope that our knowledge thereof and experience in their implementation gives weight to our comments and observations below, although we have not yet performed a detailed analysis of the differences between the proposed standards and the IAASB's standards.

These standards, as the PCAOB notes, are the foundation for further standard-setting and it is important to get them right, and allow auditors sufficient time for proper implementation. A roundtable should be considered given the need for a degree of openness with these particularly important standards and re-exposure, if necessary, should be regarded as a strength rather than a weakness.

Please contact me should you wish to discuss any of the points raised in this response.

Yours sincerely



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## **Main Comments**

### **Support for these proposed standards**

We are pleased to note that the proposed standards reflect the Board's recognition of the importance of professional judgement, sound foundational principles for standard-setting and the elimination of unnecessary differences between auditing standards across jurisdictions. We are also encouraged by the positive approach to IAASB standards; starting with the IAASB standards was the right thing to do.

We supported the IAASB's clarity ISAs and have commented on each of them. We support further convergence and the proposed standards from the PCAOB are therefore welcome. The PCAOB had only just been established in 2004 when the IAASB revised the risk ISAs and it has made great progress since then. The convergence of accounting standards and the current demands for global solutions to the current market turmoil lead naturally to the convergence of auditing standards to facilitate consistency in the audit of financial statements. The only alternative is inefficient and cumbersome questionnaires covering differences in auditing standards and a box-ticking approach to auditing rather than the exercise of the sound professional judgement necessary for effective, high quality audits.

The UK's successful standard-setting model is clear about the basis for auditing standards; the full ISAs with a small number of 'pluses' addressing specific UK legal and regulatory requirements. The AICPA is converging its auditing standards with ISAs, as are standard-setters in other developed jurisdictions including Canada and many members of the EU. We encourage the PCAOB to consider the need for more systematic and transparent convergence with ISAs, not least because it would facilitate greater reliance upon other regulators in the PCAOB's inspection process. Standards that are properly converged to the maximum extent possible with ISAs enable international networks to have one core methodology supplemented in each member firm with local regulatory differences. This would have a positive impact on the inspection process as well as audit quality, and the costs of developing single audit methodologies, training programs and audit manuals.

The PCAOB's perspective on the differences between PCAOB and IAASB standards is valuable and illuminating. We note the active contribution made by the PCAOB's representative at IAASB meetings in an observer capacity. While the comparison between ISAs and PCAOB standards is helpful, we believe that a more comprehensive analysis of the differences between the two sets of standards from the PCAOB's perspective, setting out the criteria and rationale applied in deciding whether to adopt or reject a particular IAASB or other requirement or guidance, would be particularly helpful to standard-setters, other inspection bodies and auditors. Application guidance from the ISAs has in some cases been elevated to a requirement in the proposed standards and requirements from the ISAs have not. This is not simply an issue of inconsistent wording, but of inconsistent requirements in the two sets of standards. Convergence can only be achieved in a systematic and transparent manner.

These standards will have a major impact on audits but the process for assessing their impact is not clear. There is currently no cost benefit analysis. We encourage the PCAOB to perform a simple, high level impact assessment in the light of the

issues associated with the implementation of AS 2. We do not believe that such assessments need to be lengthy or complex and we would be happy to provide an example of a qualitative assessment performed in the UK, in the context of UK corporate governance.

## **Drafting**

### *Foundational principles*

We note above our support for the idea of foundational principles on which to build further standards. The PCAOB is well aware of widespread international support for principles-based standards. It is also aware of the challenges in setting such standards where a principles-based regime is not necessarily well-understood or supported, and the importance of principles-based regulation and oversight to accompany principles-based standard-setting. However, the PCAOB is in a better position than many to overcome those challenges, as both inspector and standard-setter.

We therefore encourage the PCAOB to consider carefully the value of articulating the principles upon which the current proposed standards are, and future standards will be based. Such principles would need to articulate clearly criteria for the inclusion or exclusion of AICPA, IAASB and other material. We do not underestimate the amount of effort required to build consensus in this area but the PCAOB has a rare opportunity as a relatively 'new' standard-setter to develop a set of principles for auditing standard-setting without the 'burden' of an extensive corpus of extant standards.

### *Objectives*

One of the most difficult hurdles the IAASB faced in drafting its clarified ISAs was in establishing a coherent set of objectives against which an auditor's performance could be evaluated. The importance of objectives that were not merely aspirations, or indistinguishable from the procedures and requirements of the standards themselves, nor mere repetitions of the titles of the standards, became apparent. The IAASB has in most cases dealt with these issues but there remain imperfect examples of objectives as a result of these problems. We note below some similar issues arising in the drafting of the PCAOB proposed standards and encourage the PCAOB to learn from the experience of the IAASB.

### *Terminology*

We note an instance of the use of different terminology across jurisdictions for the same thing; footnote 22 to the additional discussion states that 'clearly trivial' means the same thing as 'clearly inconsequential'. This is just as much a problem for regulators internationally as the use of identical terms in different jurisdictions to mean different things. While it may seem burdensome to have to avoid the use of a word in its plain English context, simply because it is used in another jurisdiction with a specific technical meaning, there is a real risk that regulators operating in an international context will read the technical meaning into the use of the term in another jurisdiction where it is not intended. A good example of this was the practice of some regulators of inappropriately reading the technical meaning of the term

'material uncertainty' as used by the PCAOB into the same term used in other jurisdictions. This is sure to apply in reverse and in drafting standards the PCAOB should be aware of this risk, particularly in the context of the proposed standard on materiality, where terms already used by the IAASB are used to mean something different, without explanation.

### **Implementation date**

An implementation date is not mentioned and it is likely that some time will be needed to implement these important standards. Forum of Firm members will be implementing clarity ISAs in 2010 and if the PCAOB intends implementation for 2010 audits it must signal that in 2009. It appears that the final standards are unlikely to be issued before summer 2009 and by the time they are approved by the SEC we believe that 2011 would be the earliest possible implementation date. Small firms auditing public companies in the US will need more implementation time.

### **Complexity of US GAAS for SEC registrants**

US GAAS for SEC registrants will now be in three bodies of material; six extant PCAOB standards, the AICPA standards adopted by the PCAOB as its interim standards in 2003, and the proposed standards. The interaction of these standards is increasingly complex as the cross references and links become ever more convoluted and we see no proposed codification project in the immediate future. The lack of codification is confusing to auditors and will become even more confusing as the AICPA continues to change its own standards. Unnecessary complexity impairs auditors' ability to apply standards because it diverts attention to administration and away from the proper performance of audits.

### **Timescale**

The development of high quality auditing standards cannot be rushed but nor need it be an excessively lengthy process. The IAASB's original time-span for the completion of the clarity project was six years (2005-11); the deadline was brought forward to 2008 and the project successfully completed in just three years without compromising the quality of ISAs. We urge the PCAOB to consider a systematic revision of standards to a published timetable. In this context, the timetable for the Concept Release due in 2009 on the review of interim standards appears on the face of it to be an overly lengthy process.

### **Substantive issues**

#### *Significant risks and fraud*

There are requirements for substantive procedures for *all* significant risks, with little scope for the combination of work on controls and analytical procedures as required by ISAs; this may be onerous. Detailed substantive testing is not necessarily the appropriate response to *all* significant risks.

The introduction to the proposed standards makes much of the centrality of fraud but the ISAs have a great deal more on this in the application material. Application material is not only about the extent and effectiveness of work on fraud, but also

about efficiency and ensuring that auditors do not do too much. For example, in the proposed standard *Identifying and Assessing Risks of Material Misstatement*, Appendix 3, paragraph 52(d) describes the procedures the auditor *should* perform in all circumstances related to specific inquiries about fraud with accounting and financial reporting personnel, whereas ISA 240 paragraph A16 provides guidance that permits the auditor to use professional judgment in determining to whom in the entity it is most appropriate to direct fraud inquiries.

## Detailed Comments

### ***Audit Risk in an Audit of Financial Statements***

1. Paragraph 10: the level of detection risk is reduced through the performance of tests of controls, as well as substantive procedures.

### ***Audit Planning and Supervision***

2. Paragraph 6: items (a) and (c) are largely practice management issues and to the extent that they are covered in ethics requirements, are caught by (b) in any case. Either (a) and (c) should be deleted, or, if there is a need to emphasise the ethical aspects of these issues, the paragraph might read

'The auditor should evaluate whether the ethical aspects of client acceptance and engagement preliminaries have been properly addressed, including the following:

- Acceptance or continuance of the client relationship
  - Compliance with independence requirements
  - Ensuring that the client understands the nature of the audit and other services to be performed'.
3. Paragraph 7: it is difficult to imagine how any of the matters listed would not be important to the audit provided that they are relevant and the words '*whether the following matters are important to the company's financial statements and internal control over financial reporting and if so*' could be deleted. It is arguable that this aspect of planning is in any case covered by risk assessment, that there is an overlap with paragraphs 8-19 of the standard on identifying and assessing risks, and that the material should be included there. This would be more in line with clarified ISA 300, *Planning an Audit of Financial Statements*.
  4. Paragraphs 13 et seq: it would be helpful to deal with the issue of IT specialists in PCAOB standards in some other way than singling them out for particular attention in many different standards, particularly given that they now form a sub-category of an ever-widening range of 'other' professionals whose work is used by auditors.

### ***Identifying and Assessing Risk of Material Misstatement***

5. Paragraph 3: the word '*appropriately*' is redundant and without it is a bare repetition of the title of the standard. Generally speaking, the auditor should be required to achieve a particular outcome in the interest of an objective. So the objective, as with the IAASB standard, might have words such as '*...and thereby provide a basis for designing and implementing responses to the assessed risk of material misstatement.*'
6. The word '*appropriately*' appears again in paragraph 5 but is then abandoned in the first sentence of paragraph 56.
7. Paragraph 12: bullets 3 and 4 should be reversed – the latter will normally be more important than the former.

8. Paragraph 22: it is important to make a clear distinction between the evaluation of the design and implementation of controls in the context of obtaining an understanding (as here) and need to do so in the context of the response to assessed risks. The extensive forward cross-referencing here may give the impression that they are one and the same thing when in fact the former should require less depth than the latter.
9. Paragraph 26 refers to '*sound integrity and ethical values*'. Paragraph 48 refers to '*honesty and integrity*', paragraph 65 refers to '*honesty and ethical behaviour*' – all in the context of management. Furthermore, paragraph 23 of Evaluating Audit Results refers to the '*integrity*' of management. These need to be aligned. Honesty, integrity and ethical values are all evidenced by, and characteristic of, ethical behaviour, which is the all-encompassing category. There is no need to use two terms.
10. Paragraph 32: the last two bullets refer to the quarterly financial statements which should only be addressed to domestic issuers and not foreign private issuers in the context of the period-end reporting process.
11. Paragraph 34: gives no indication as to what control activities are.
12. Paragraph 52 (d): requiring auditors to solicit employee views on the aggressiveness (or otherwise) of the application of accounting policies decided on by management is a risky strategy; it smacks of snooping. It risks creating expectations that cannot be fulfilled, breeding distrust between management, auditors and employees and is likely to be unworkable.
13. Paragraph 55: more would be helpful on inconsistencies in responses and management fraud.
14. Paragraph 56 (b): '*and/or*' in the second line rather than '*and*' might be helpful.
15. Paragraph 56 (d): to permit auditors to take account of planned reliance on controls in assessing the magnitude of potential misstatement seems back to front.
16. Paragraph 56(e): this deals with identifying significant accounts or disclosures determined exclusively on the basis of inherent risk. Significant accounts and control risk surely come first?
17. Paragraph 63 (a): not all fraud risks are significant risks. It would be helpful to re-iterate here that fraud risks, as used in this context, are risks that could result in material misstatement, as per paragraph 28.

### ***The Auditor's Responses to the Risks of Material Misstatement***

18. No detailed comments



### ***Evaluating Audit Results***

19. Several of the requirements of this proposed standard seem to amount to either a requirement to re-audit certain areas or to perform procedures that are properly part of a firm's quality control processes. Paragraphs that could fall into either or both categories include paragraph 7,
20. Paragraph 15 (b): the phrase '*greater than an appropriately low level of risk*' in the first part of the note seems to be intended to mean the same as '*...this risk is unacceptably high...*' in the second part. If so, the same term should be used and if not, the difference explained. Anything that is greater than appropriately low must, by definition, be unacceptably high.
21. Paragraph 15 (b) Note: it is not clear what the additional procedures might be or what '*determine*' means. It is more likely that the auditor will tell the client to book the adjustment. Sometimes more work is not the answer.

### ***Consideration of Materiality in Planning and Performing an Audit***

22. Paragraph 5: the word '*surrounding*' is redundant.
23. Some of the explanatory material which currently appears in the Additional Discussion might usefully be incorporated into this standard, particularly given that the PCAOB has adopted terms other than those used by the IAASB. For example, the description of a reasonable investor on page A9-28 might help explain the term in paragraph 7, and '*material*' in paragraphs 8 and 10 might be supported by some of the explanatory material on pages A9-29.

### ***Audit Evidence***

24. The difference in the wording of the objective in paragraph 3 and the wording in paragraph 4 is unhelpful.
25. Paragraph 9: the requirement to modify or perform additional procedures in cases of suspect authenticity needs a link to professional skepticism, and further circumscription; many modifications are routine and to treat them as suspect may create inappropriate expectations.