Mr. Tom Ray  
Chief Auditor  
Public Company Accounting Oversight Board  
c/o Office of the Secretary  
1666 K Street, N.W.  
Washington, D.C. 20006-2803  
USA  

By E-mail: comments@pcaob.org  

February 18, 2009  

Dear Tom,  

Re.: 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  

We would like to thank you for the opportunity to comment on the PCAOB’s Proposed Auditing Standards Related to the Auditor’s Assessment of and Response to Risk And Conforming Amendments to PCAOB Standards (hereinafter collectively referred to as the “proposed standards”). We are commenting on these proposed standards because they are directly relevant to the members of the German Wirtschaftsprüfer profession that audit the financial statements of SEC-registrants or their subsidiaries, and because PCAOB standards do influence standards setting elsewhere, including that of the International Auditing and Assurance Standards Board (IAASB).

We welcome the updating of the PCAOB’s interim standards that deal with audit risk and introduce the “risk assessment” and “risk response” paradigm currently effective in the International Standards on Auditing (ISAs), in the AICPA Auditing Standards, and in many other standards throughout the world, including our IDW Auditing Standards. We particularly welcome the efforts made to align the
proposed standards with the ISAs, because this furthers the overall objective of international convergence of auditing standards needed for international capital markets. As a matter of principle, we also welcome the introduction of objectives into the standards to act as a guide to the auditor in considering whether the application of the requirements has achieved the objective desired.

We also find favor with the 120 day comment period. We specifically support the comments made by Daniel L. Goelzer in relation to the need for further development of due process. Given the international significance of PCAOB standards, we believe that they require a transparent due process throughout their development.

We recognize that at this stage, in which the PCAOB has chosen not to exercise its mandate under Section 103 (a) 3 (A) (i) of the Sarbanes-Oxley Act to adopt other auditing standards, such as the ISAs, the PCAOB would issue auditing standards that contain some differences to the ISAs because the PCAOB’s standards:

1. take into account U.S. securities laws and SEC and other PCAOB rulemaking in relation to these laws;
2. are written in the context of an integrated audit of the financial statements and of internal control over financial reporting, as opposed to only focusing on the audit of the financial statements,
3. are consistent with those PCAOB interim standards that have not yet been revised or updated and that represent counterparts to ISAs that have been revised by the IAASB in the last three or four years, and
4. do not include matters in the ISAs that are not applicable to audits of the financial statements of SEC-registrants.

However, we question the need for any differences between the ISAs and the proposed standards beyond these situations, and, based upon our reading of the proposed standards, surmise that the application of these situations has been interpreted too broadly.

The IAASB’s auditing standards reflect the product of an intensively overseen and thorough due process involving considerable consultation at an international level, including input from regulators, such as the PCAOB. We believe that international convergence of auditing standards towards the ISAs is important for international capital markets. Consequently, although as national standards setters in Germany, there are issues that we believe that could be addressed, or addressed differently, in the ISAs, that could improve the ISAs, we
would generally refrain from departing from the ISAs when we transpose these into national standards, unless situations in Germany that are analogous to the four identified above apply. For these reasons, we do not believe it to be conducive to international convergence of auditing standards for the PCAOB to write auditing standards that differ from the ISAs at a technical level for reasons other than those clearly related to the four situations noted above.

As the current financial crisis has shown only too clearly, the U.S. economy is not an isolated island. We therefore believe it to be in the long term interests of not only global capital markets, but also of the American capital market and its U.S. investors that auditing standards in the world converge towards a single set of high quality auditing standards, just like the world, including the U.S., at the present time appear to be converging towards one set of high quality financial reporting standards (IFRS) for publicly listed entities. To this effect, the ISAs are the most widely accepted benchmark of high quality auditing standards at an international level because of the IAASB’s intensive and internationally oriented due process. Therefore, due to their impairment of international convergence of auditing standards, differences between the ISAs and the proposed standards not clearly justified by the four situations noted above should be minimized as far as possible.

Furthermore, differences between the ISAs and the proposed standards that cannot be avoided due to the four situations noted should be made as transparent as possible. This means that, to the extent possible, the placement (i.e. in which standards), structure (i.e. the order within a standard) and wording of the requirements in the proposed standards should be aligned as far as possible to ease comparison and reconciliation. We found it extremely difficult to compare the nature and extent of requirements in the proposed standards to the ISAs and our standards because the PCAOB chose to place some requirements in other standards than in those commensurate to the ISAs (e.g. many of the requirements in relation to fraud, which are included in the risk assessment and response proposed standards, rather than the fraud standard), ordered the requirements differently, and used different wording when using the same would have appeared to have been adequate. As a result, reconciling firm audit methodologies between the ISAs and the proposed standards may be a very difficult and costly exercise for the audit firms affected.

We also note the tendency of the proposed standards to include matters that are in the application material of the ISAs into lists of presumptively required procedures of the proposed standards. We are not convinced that creating further “checklists” of procedures to be done, whether or not they are relevant or
significant, without further thought and application of professional judgment by the auditor will lead to a better audit: it will lead to precisely that kind of checklist mentality that is detrimental to a good quality audit. We therefore recommend that the PCAOB rethink its strategy on auditing standards to move towards a more top-down principles-based approach and to therefore consider removing some of these presumptive requirements and placing them into the accompanying explanatory material of matters that the auditor may consider in the circumstances.

In the enclosed Appendix to this comment letter, we have addressed a number of what, in our view, are the more important differences between the proposed standards and the ISAs that have come to our attention through the review of the proposed standards, that we believe need not be maintained in the proposed standards. The matters addressed do not represent all of the potential differences that we have identified. Furthermore, given the difficulties noted in comparing and reconciling the ISAs with the proposed standards, we cannot claim that we have identified all of the important differences, let alone all of the less important ones.

If you have any further questions about our comments, we would be pleased to discuss our comments with you.

Yours very truly,

Klaus-Peter Feld Wolfgang Böhm
Executive Director Director International Affairs

Appendix
APPENDIX

Proposed Auditing Standard – Audit Risk in an Audit of Financial Statements

In the second sentence of paragraph 3, reference is made to “applying due professional care and obtaining sufficient appropriate audit evidence”. In our view, due professional care and obtaining sufficient appropriate audit evidence are not separate issues: in the context of obtaining reasonable assurance, an auditor exercises due professional care only if he or she has obtained sufficient appropriate audit evidence. Consequently, we suggest changing the wording to read “exercising due professional care by obtaining sufficient appropriate audit evidence”.

Proposed Auditing Standard – Audit Planning and Supervision

We find the inclusion of the requirement in paragraph three in the objectives section confusing: shouldn’t the objectives section only include objectives?

Many of the issues addressed in paragraph 7 may be better placed in the risk assessment standard (as in the ISAs), rather than as part of planning, since these matters relate to the obtaining an understanding of the business aspect of risk assessment.

The references in paragraphs 14 and 15 to individuals needed for specialized skill or knowledge in relation to IT appear to us to be an attempt to incorporate thoughts from the revised ISA 620 into the proposed planning standard. Furthermore, it places undue emphasis on specialized IT skills compared to other specialist skills that may be needed for the audit. For this reason, we suggest that the proposed planning standard not address these issues, but that these issues be addressed as part of a standard on using the work of specialists generally, and not necessarily in the requirements.
Proposed Auditing Standard – Identifying and Assessing Risks of Material Misstatement

We do not understand the reason for the objective to be different than that expressed in ISA 315.03, which is more precise. We suggest that the proposed standard be revised to align the objective with that in ISA 315.

The use of the words “should consider” in paragraph 13 will have the effect of requiring the auditor to justify for each bullet point why a certain procedure was not performed, rather than having auditors take a top-down approach to determining which audit procedures they ought to be performing in the circumstances. This leads to a checklist approach to the issues identified, which is not conducive to audit quality.

We are concerned with the list of presumptive requirements in paragraph 19, which includes the words “if applicable”. If a matter is not generally applicable, it should not be included as a presumptive requirement, but in additional explanatory material. This list will cause auditors to have to justify in each case why something is or is not applicable and therefore lead to a checklist mentality on the audit, which is not conducive to audit quality.

Paragraph 20 states that the auditor should obtain a sufficient understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatements, (b) assess the factors that effect the risks of material misstatement and (c) design further audit procedures. We have a number of difficulties with this requirement. First, we would like to point out that, unless the auditor does a combined inherent risk and control risk assessment (a misstatement risk assessment), an auditor identifies types of potential misstatements by examining inherent risks without including the effect of control risk. This is in fact required by the ISA 315.26 for significant risks. Second, some components of internal control only affect the misstatement risk at the financial statement, rather than assertion, level. Consequently, obtaining an understanding of these components will not lead to the ability to identify types of potential misstatements, which is an assertion-level concept. Third, the only factors that affect the risks of material misstatement are inherent and control risk: does this mean that by requiring an assessment of the factors that effect the risks of material misstatement, the PCAOB is requiring a separate, rather than combined, risk assessment, for all cases, including risks that are not significant risks? This seems to be at odds with other requirements in the standards. Furthermore, what is now left (sufficient understanding of internal control to design further audit procedures) would have been covered by the objective of the standard if the objective used in ISA 315.03 had been applied. It is therefore redun-
Paragraph 38 of the proposed standard specifically requires the auditor to incorporate knowledge obtained in past audits in the risk assessment of subsequent audits. The ISAs (see ISA 315.09) are more cautious in this regard because the real issue for auditors is whether this information is still relevant. We suggest that the PCAOB consider being more cautious on this issue by aligning its requirement with that of ISA 315.09.

Paragraph 41 states that the “auditor should assess” whether information gained from other engagements performed by the auditor is likely to be important for identifying risks. There are two issues of concern here. First, the word “auditor” could mean the audit firm. It is unlikely that audit firms will be in a position to convey only relevant information from one team performing an unrelated non-assurance engagement at the company to another performing the audit without developing very costly reporting systems between engagement teams; there may even be confidentiality barriers. The ISAs resolve this problem by addressing the engagement partner only. Second, even if the engagement partner becomes privy to information from another completely unrelated engagement, the engagement partner need not “assess” the relevance of that information, but need only consider whether it may be relevant at that stage. An “assessment” involves a detailed evaluation process, as opposed to a “consideration”, which involves thought on the part of the engagement partner. We suggest that the proposed standard be aligned to the ISAs.

The use of the phrase “analytical procedures designed to” in paragraph 42 suggests that such analytical procedures are more effective than they actually are in covering items (a) and (b). As pointed out in the ISAs (ISA 315.6(b) together with ISA 315.A7), analytical procedures contribute to an auditor’s understanding of (a) and (b), but only in conjunction with other procedures.

It seems to us that the requirement in paragraph 46 provides a gratuitous definition of who “key engagement members” are without adding any real guidance because it interprets the word “key” by using the term “significant engagement responsibilities”, which is not particularly helpful. Furthermore, one would presume that the discussion would cover only important matters, which makes the following requirement to communicate important matters to the other engagement team members too restrictive. On the other hand, it begs the question of “important to whom”? The solution in ISA 315.10.02 is more practical in that the engagement partner makes the determination of what needs to be reported to whom on a “need to know” basis.
Paragraph 48 represents a rules-based approach to audits by including a “checklist” of matters that should be covered in the discussion among team members about potential misstatements due to fraud. Not all of these matters may be relevant on all audits, and there may be matters that are relevant that are not on the list (see ISA 240.A11). We therefore suggest that the PCAOB consider whether guidance on this matter may be more helpful than a list of requirements.

Paragraph 49 requires specific communication of items that are required of auditors on all audits. This is a rather strange and even redundant requirement. Once having communicated these matters to all audit staff at a firm, why would they need to be communicated again on every engagement? This is a matter that ought to be addressed as part of the fraud standard in terms of the overall stance taken by team members on all audits, not as part of risk assessment for each audit.

Paragraph 50 contains the requirement that auditors make inquiries of those within the company that “might reasonably be expected to have information”. This is a very open-ended requirement that begs the question, “reasonably expected by whom? The auditor? The PCAOB? The courts? From our point of view, with hindsight any third party will always be able to claim that the auditor should have made an inquiry of someone that he hadn’t. In our view, as described in ISA 315.06(a), it is the auditor’s judgment that is paramount in this situation: no one else was there at the time and there shouldn’t be any second-guessing with hindsight unless the auditor’s judgment was clearly unreasonable in the circumstances.

Paragraph 52 d addresses inquiries of accounting and financial reporting personnel. This is also a very open-ended requirement, because auditors would then need to perform all of the procedures in (1) to (4) for all such personnel, which is clearly unreasonable. Furthermore, such a procedure may not always be effective, depending upon the position and nature of the individual. In our view, this matter is a procedure that the auditor may wish to consider in appropriate circumstances, but not one that should be done all of the time. We therefore suggest that this requirement be replaced by guidance.

Paragraph 54 contains the requirement that auditors make inquiries of those within the company that “might reasonably be expected to have information”. This is a very open-ended requirement that begs the question, “reasonably expected by whom? The auditor? The PCAOB? The courts? From our point of view, with hindsight any third party will always be able to claim that the auditor should have made an inquiry of someone that he hadn’t. In our view, as de-
scribed in ISA 315.06(a), it is the auditor’s judgment that is paramount in this situation: no one else was there at the time and there shouldn’t be any second-guessing with hindsight unless the auditor’s judgment was clearly unreasonable in the circumstances.

Proposed Auditing Standard – The Auditor’s Response to the Risks of Material Misstatement

We do not understand why the objective in paragraph 3 of the proposed standard needs to depart from the very precisely worded objective used in ISA 330.03. We suggest that the wording in the proposed standard be aligned to that in the ISAs.

We note that the objectives and the requirements relate to responses to the risks of material misstatement, rather than to the assessed risks of material misstatement. We do not find the explanation on Pages A10-4 to A10-5 to be convincing. We would like to point out that an auditor obtains reasonable – not absolute – assurance. This means that even if an auditor has performed an appropriate risk assessment in compliance with PCAOB auditing standards, the actual risks may be significantly different from those assessed. However, an auditor can only respond to the assessed risks – not to the actual risks, which are unknown. If an auditor’s inappropriate assessment of risks that is not in compliance with PCAOB auditing standards leads to appropriate responses to inappropriately assessed audit risks, then the noncompliance with PCAOB auditing standards relates to the inappropriate assessment, not the appropriate response to the inappropriate assessment. By requiring an appropriate response to actual misstatement risks, rather than to those assessed, the PCAOB is setting a standard that is impossible to meet in practice or theory.

We believe that it is important for auditors to implement overall responses to risks at the financial statement level because these risks are pervasive to the financial statements: they would be difficult to address only at the assertion level. For this reason, we do not share the view of the PCAOB that an auditor need not match overall responses to misstatement risks at the financial statement level. Such a requirement does not lead to the auditor being able to avoid performing audit procedures to address risks of material misstatement at the assertion level at all and therefore such a requirement ought to be included in the proposed standard.

We are concerned with the requirement for substantive tests of details for all relevant assertions for significant accounts or disclosures, and for all significant
risks. We would like to point out that in some cases, performing substantive
tests of details rather than, or in addition to, tests of control and analytical review
procedures may not obtain any additional assurance because the tests of detail
may not be relevant. For example, for some cases, as identified in ISA 315.29,
for risks for which substantive procedures alone do not provide sufficient appro-
priate audit evidence (e.g. the completeness assertion or some fraud risks),
substantive tests of details may be irrelevant. For this reason, we believe that
the requirement to perform such substantive tests of detail for all relevant asser-
tions, as described in paragraph 40 of the proposed standards is inappropriate
and needs to be deleted. Likewise the requirement for substantive tests of de-
tails for all significant risks in paragraph 45 is inappropriate and should be de-
leted.

The requirement in paragraph 49 to compare relevant information about the ac-
count balance at the interim date with comparable information at the period end
presumes that there will always be comparable information. In our view, re-
quirements should not be introduced for situations that may or may not exist on
most audits, unless there is an overriding need for a requirement predicated
upon such existence, even if it is rare. We do not see such an overriding need
when auditors are already required to test the remaining period.

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

We believe that this proposed standard would benefit from a discussion of mate-
riality by at least conveying the discussion of materiality from the appropriate
FASB standards or concept statements and the description provided by the
courts. Furthermore, the proposed standard would greatly benefit from the mat-
ters discussed in ISA 320.04, which forms the basis for an auditor’s considera-
tion of materiality and does not appear to be inconsistent with the concept of a
reasonable investor under U.S. securities law.

We note that the proposed standard uses the term “tolerable misstatement”
from AU §350 Audit Sampling rather than the term “performance materiality”
used in the ISAs. This would be appropriate if “tolerable misstatement” as de-
defined in AU §350 is the same as the meaning of tolerable misstatement in the
proposed standard. However, we would like to point out that the two concepts
are equivalent for a particular financial statement item only when sampling the
entire population of items comprising that financial statement item (i.e. one
could select particular items included in that financial statement item for testing
and draw a statistical sample for testing on the remaining items). When sam-
pling less than all of the population of items comprising a financial statement item, “tolerable misstatement” for statistical purposes for the sampled population (which would be a portion of the total population of the financial statement item) would be different than the “tolerable misstatement” applied to that entire financial statement item (which may or may not be the same as the “tolerable misstatement” for the financial statements as a whole) to reduce to an appropriately low level the risk that the aggregate of uncorrected and undetected misstatements in that item exceeds the materiality for that item (which may or may not be the same as the materiality for the financial statements as a whole). For these reasons, we question whether it is appropriate to use the same terms for statistical sampling and for reducing to an appropriately low level the risk that the aggregate of uncorrected and undetected misstatements in an item exceeds materiality for that item.