January 2, 2007

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

Re: PCAOB Rulemaking Docket Matter No. 21
Proposed Auditing Standard – *An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements And Related Other Proposals*
December 19, 2006

Dear Board Members,

I am submitting my comments to you regarding the above referenced Rulemaking Docket Matter. These are my personal comments and do not necessarily reflect those of my employer. You specifically asked respondents to answer thirty-four (34) questions. I begin with some observations on paragraphs 1 through 15 on page A1–4 to the top of page A1–11.

Par. 1. – The Public Company Accounting Oversight Board ("PCAOB" or "the Board") states the new standard "applies when an auditor is engaged to perform an audit of management's assessment of the effectiveness of internal control over financial reporting...that is integrated with an audit of the financial statements." [Footnote and boldface type are eliminated.] This introductory paragraph seems to permit an auditor to bifurcate the audits. If the Board truly intends to *require* integration of an audit of internal control over financial statements with financial statement audit procedures, I recommend making a direct statement here. See my comments on paragraph 7 and question 19 below.

Par. 2. – This paragraph concludes with the statement, "A material weakness in internal control over financial reporting may exist even when financial statements are not materially misstated." Later in paragraph 72 on page A1–27, the Board states this again. To someone unfamiliar with auditing and the concept of "reasonable assurance," this must read like an oxymoron. "How," one may ask, "can there be a very serious problem with internal control over how the numbers are reported, but not a problem with the numbers that have been reported?" The Board mentions adjusting financial statement audit procedures beginning on the bottom of page A1–19 in paragraph 46. Let us consider basic safety standards to aid those who may not understand. One may remove oil soaked rags from a pile of paper not because there was a fire, but the *potential* of a fire exists. It appears that this is what the Board is promoting. Nonetheless, management and auditor will have to communicate. The imagination of the auditor will be assessed by management in these cases.

Par. 5. – Whether in this paragraph or another section to follow, I recommend discussion of how multiple locations may have different *specific* controls under a standard framework promulgated by the parent company (corporate headquarters). For example, a large company may provide this broad company-level control: "The VP Finance or Controller is the only person who may

open a new bank account. Approval for the new account must be secured from Corporate Treasury." One business unit or division may have only one of those two titles. Therefore, they write their version of the control: "The Controller may open a new bank account when needed after receiving an approved 'Request for New Bank Account' form from the Corporate CFO." The Board may find it helpful to make this paragraph more robust directing the auditor to acquire and test the *local* framework as approved by the corporate powers that be.

Par. 7. – This paragraph is presently written as a *suggestion* by stating that the audit of internal control over financial reporting "should be integrated with" the financial statement audit. Appendix B provides more detailed guidance. I note that paragraph B1 starts with the phrase, "In an integrated audit of internal control over financial reporting and the financial statements..." This again leads to the possibility that these two audits may not be concurrent. See my reply to question 4.

Par. 8. – Integrating the audit guides the auditor in the reverse direction, too. The auditor must assess risk of misstatements on the financial statements. Therefore, the processes that yield the numbers and disclosures surrounding these risk points ought to lead the auditor to assess internal control risk accordingly. This means if Inventory is deemed to be high risk, perhaps more so given the particular client, the internal controls surrounding inventory need to get more attention. The Board hints that stronger internal control may reduce the risk of material misstatement in an area. What is being described here is how internal controls over financial reporting and the financial data produced are integrated by definition; a lattice if you will. Data is entered in the system after passing through a prescribed process. The natural extension of the process requires we retrieve that data to ensure it is accurate. Continuing with the example, a well-controlled process for inventory data input and usage reduces our risk of misstating inventory. The only exposure remaining is the process of inventory valuation. While circular in appearance, the auditor has gone from assessing the risk of a material misstatement of inventory to finding strong controls to reduce that risk. This in turn leads to reduced testing on the financial statement audit. The auditor may opt to spend more time on the internal control audit to ensure this. Overall, the amount spent may go down. If controls are weak, then the auditor needs to broaden procedures on the financial statement side, while spending *less* time on testing internal controls, which may not prevent misstatement of inventory.

Par. 9. – The Board presents this standard as benefiting smaller companies rather than all companies. Why ignore the "accelerated filers," who are ending the third year of compliance with Section 404 of the Sarbanes-Oxley Act of 2002 ("SOX 404"). I agree with scaling the audit of internal control over financial reporting. I recommend that the Board make it clear that everything presented in this standard applies to integrated audits of all companies.

Par. 10. – The fifth bullet point is an indication of *increased* risk in my opinion. Managers with broad control may direct the auditor to assess the overall control environment and company-level controls in greater depth. The familiarity between senior management and company personnel, as mentioned in paragraph 11, may permit a manager to bypass a control–especially when unwritten–without being second guessed by the employee.

Par. 12. – The Board may find it helpful to include discussion in the first bullet point that the lack of client documentation will require the auditor to supplement with their own documentation of what was observed. This leads to more detailed walkthrough documentation. Segregation of duty issues are mentioned in bullet four. A division or business unit of a larger company may face a similar dilemma. In the fifth bullet point the Board writes of control performer competency. Suppose an auditor finds that a person in the accounting department actually has a degree in English (more likely in a small company). If the auditor feels this person is not competent to properly perform the internal controls under his or her purview, how can the auditor trust the numbers produced by the process? The auditor ought to expand testing in this area of the financial statement audit. If the numbers are deemed to be fairly accurate, would this rescind the auditor's premise of a lack of competency? I suggest it does. This premise nicely ties to the Board's later requirements presented in paragraphs 65 through 69. Finally, I suggest the Board add some reference to the use of spreadsheets in the sixth bullet point. Smaller companies may rely heavily on spreadsheets, even with very good software programs available. A small manufacturer may not have an integrated software package that handles job costing and the general ledger simultaneously. Data may have to be extracted from the job costing system, passed through a spreadsheet to yield journal entries, and then be input to the general ledger. The Board may not feel comfortable presenting guidance on how auditors ought to test software and spreadsheet packages. However, coordinating with another organization may be very helpful.

Directing the Auditor's Attention Towards the Most Important Controls

1. **Does the proposed standard clearly describe how to use a top-down approach to auditing internal control?**

   The Board wisely presented detailed information in the order the Board wants the auditor to follow.

2. **Does the proposed standard place appropriate emphasis on the importance of identifying and testing controls designed to prevent or detect fraud?**

   Paragraph 31 on page A1–16 is a double-edged sword. To answer this question it clearly instructs the auditor to consider how misstatements occur, most likely due to fraud. See my response to question 3 below.

3. **Will the top-down approach better focus the auditor's attention on the most important controls?**

   I wrote above in my response to question 2 that paragraph 31 points the auditor in the direction of fraud detection by asking "what could go wrong?" It has been my experience that auditors asking this question quickly revert to a bottom-up approach. An auditor may want to know how a company prevents a false timesheet from being entered. If the auditor follows the top-down approach, he or she may discover that in order for a timesheet to be entered, the employee has to be entered by Human Resources and the

payroll requirements must be entered by Payroll. To wrap the process up in a neat package, a computer-based timekeeping system may prevent an employee from charging an expense or project to which the employee is not assigned. This company-level set of controls mitigates the possibility of a false timesheet being entered especially when combined with supervisory review. It may be harder to prevent fraud where paper timecards may be in use, unless there are fewer employees in one location. Therefore, I recommend cautionary words here directing the auditor to develop tests for fraud and asking “What if” *after* the auditor makes an initial determination of what controls to test.

4. Does the proposed standard adequately articulate the appropriate consideration of company-level controls and their effect on the auditor’s work, including adequate description of when the testing of other controls can be reduced or eliminated?

I recommend merging the first two sentences in paragraph 16, page A1–11, to read, “A top-down approach to select the controls to test begins at the financial statement level...” Throughout the proposed standard the Board employs the word “should” and does so here regarding the use of a top-down approach. “Should” is the past tense singular of “Shall,” and it is also conditional. It is true that more current usage equates “should” with “must.” I believe the Board ought to use the word “must” if that is the true intention, as you do in paragraph 19, page A1–12. Lastly, paragraph 22, page A1–13, may include a bullet on period-end due dates, *i.e.*, are they too aggressive leading to exhausted people trying to complete the numbers.

Emphasizing the Importance of Risk Assessment

5. Does the proposed standard appropriately incorporate risk assessment, including in the description of the relationship between the level of risk and the necessary evidence?

On page A1–22, paragraph 53 is very important, and I agree with its premise. The conventional wisdom in place as of this writing is that just one exception causes the entire sample to be spoiled. For instance, if a control is to be tested with a sample of sixty (60) items, and tests are evenly spread throughout the year, if the sixtieth (60th) item is an exception, a new “clean” sample of sixty (60) must be obtained. Perhaps the Board can include a brief discussion of acceptable deviation rates in statistical testing.

Inquiry regarding a control generally confirms what has been learned during the walkthrough. The Board may add to paragraph 55, page A1–22, that inquiry either confirms the control has not changed, or permits the auditor to update walkthrough documentation of a significant process.

Reperformance ought to be used only for high risk controls, especially where the auditor is uncertain as to the skills and competency of the control performer. Management can reduce costs using a similar approach. Would an auditor want to re-perform all bank reconciliations if the performer is deemed to be competent? Management may be able to avoid this as well. This is *not* to say that re-performing a sub-sample is not needed to ensure the reconciliation was correctly performed as presented in control documentation.

6. Would the performance of a walkthrough be sufficient to test the design and operating effectiveness of some lower risk controls?

I advise altering the first sentence in paragraph 36 on page A1–17 to read, "The auditor ~~should~~ must perform a walkthrough for each significant process, and ought to consider performing a walkthrough of other processes to reduce or eliminate testing in those lower risk areas." I hope this sentence captures the Board's intention.

Revising the Definitions of Significant Deficiency and Material Weakness

7. Is the proposed definition of "significant" sufficiently descriptive to be applied in practice? Does it appropriately describe the kinds of potential misstatements that should lead the auditor to conclude that a control deficiency is a significant deficiency?

I am concerned that the use of the word "significant" to describe a process, an account, and a deficiency will be problematic to management, auditors, and courts. We start with a "significant process" to determine what areas provide us with "significant accounts." These numbers and related disclosures have controls surrounding them that management assesses and auditors may also test. Because the Board uses "significant" to describe these areas, and they are important enough to warrant all of this attention, to suggest that a "significant deficiency" ought to be noteworthy, but *not* a major (material) issue may be confusing. Professional judgment is gray enough. I recommend eliminating this middle class deficiency. A deficiency would then be either a "control deficiency" or a "material weakness." Materiality is a number derived by the auditor for both financial statement and internal control over financial statement reporting purposes, therefore less gray.

8. Are auditors appropriately identifying material weaknesses in the absence of an actual material misstatement, whether identified by management or auditor? How could the proposed standard on auditing internal control further encourage auditors to appropriately identify material weaknesses when an actual material misstatement has not occurred?

I commented on paragraph 2 that auditing procedures on the financial statements and internal control over financial reporting form a lattice. I reiterate that one must ask oneself whether a material weakness exists if there is *no* material misstatement. This is especially true where compensating controls are in place. The auditor must document his or her opinion that a material misstatement can occur and communicate this to management. Referring to the example I used in my paragraph 2 comment, the auditor documents evidence that oil soaked rags create small amounts of heat–studies, insurance records, etc. When oil from the rag is absorbed by paper, the amount of heat needed to ignite the paper decreases. Therefore, while no fire has occurred as of this date, the company needs to remove the oily rag and paper to prevent a fire. In SOX 404 parlance, the company needs to match purchase orders, receiving reports and invoices prior to paying a vendor invoice.

9. Will the proposed changes to the definitions reduce the amount of effort devoted to identifying and analyzing deficiencies that do not present a reasonable possibility of material misstatement to the financial statements?

In theory the Board's decision to rely upon a definition that has been in the accounting and auditing domain ought to reduce the effort. If the Board eliminates the middle category as suggested in the response to question 7, this may further reduce the effort.

Revising the Strong Indicators of a Material Weakness

10. Should the standard allow an auditor to conclude that no deficiency exists when one of the strong indicators is present? Will this change improve practice by allowing the use of greater judgment? Will this change lead to inconsistency in the evaluation of deficiencies?

It appears the Board will permit an auditor to conclude that no deficiency exists when the fourth bullet point of paragraph 79, page A1–30, exists. It may better serve users of the standard if this item is either placed in a separate paragraph or includes an introductory sentence specifically stating that the auditor may conclude no deficiency necessarily exists if this specific issue is found. In addition, one may argue that the second bullet may not necessarily lead to a deficiency, especially if management identified the misstatement through a new or improved internal control process. It could be that management opted to restate to be consistent with the current year's presentation, which would not necessarily be due to a change from one generally accepted accounting principle to another.

I believe that bullet points one and three are *prima facie* indicators of deficiency. If either of those exists both management and auditor ought to be instructed to report a material weakness.

Bullet point five may be a clear indication of deficiency *especially* for large, complex companies that ought to have an internal audit department. Smaller companies may not have the ability to employ internal audit staff. The Board may be aware that many companies have started to employ personnel strictly for SOX 404 compliance efforts in order to maintain internal audit staff independence. I recommend that the standard include consideration for the size and complexity of the company.

I suggest the Board either eliminate bullet point six or remove the language stating that only complex entities in regulated industries may be deficient due to regulatory compliance efforts. If, for example, a small regional airline company has trouble meeting Federal Aviation Administration ("FAA") requirements, it is more likely the FAA will impose sanctions against them–harming their financial performance. An airline may have a company-level control process regarding maintenance and inspections. One may argue that smaller companies may have a more difficult time meeting requirements, such as workers' compensation insurance, health benefits, sales tax remittance, etc. due to cash flow requirements.

In my response to question 7 above I mention the gray realm of professional judgment. I appreciate the Board's reluctance to impose requirements or draw a bright line for auditors to follow. Having reviewed external audit firms' reports from the Board for 2004 and 2005, it appears the number one issue raised is "insufficient evidence." This is a judgment area. At the time of the audit procedures, the auditor was satisfied with the evidence gathered. Upon further review, and I am assuming that it was PCAOB review because I do not have access to the correspondence, the evidence was deemed lacking. If it is hard enough to determine how much evidence is required to determine that accounts receivable is presented fairly in all material respects, then how can an auditor have confidence that deficiencies are properly categorized? I hope that the Board takes my advice to separate these items in paragraph 79, bottom of page A1–29 to the middle of page A1–32, into one group that may not be a deficiency and another group that are *de facto* deficiencies.

<u>**Clarifying the Roles of Materiality and Interim Materiality in the Audit**</u>

11. Are further clarifications to the scope of the audit of internal control needed to avoid unnecessary testing?

I like the Board's decision to directly tie materiality for financial statement audits to those of internal control over financial reporting. Any further attempt to define or clarify may create more questions.

12. Should the reference to interim financial statements be removed from the definitions of significant deficiency and material weakness? If so, what would be the effect of the scope of the audit?

I have suggested above that "significant deficiency" be removed. Therefore, reference to interim financial statements in the Board's proposed definition in paragraph A12 on page A1–48 would be moot. Regarding paragraph A8 on the previous page, until and unless the Security and Exchange Commission decides that interim (quarterly) financial statements do not expose a registrant and/or registrant's external auditor to legal action, the reference to interim statements ought to be maintained. Even a short-term impact on markets may have a negative affect on investors.

<u>**Removing the Requirement to Evaluate Management's Process**</u>

13. Will removing the requirement for an evaluation of management's process eliminate unnecessary audit work?

Absolutely! The requirement for the auditor to assess the competence and objectivity of the internal control over financial reporting tester, reviewer and/or SOX 404 project manager ought to cover this evaluation.

However, the Board counters this in the accompanying proposed standard *Considering and Using the Work of Others in an Audit*. Paragraph 10 of that proposed standard on page A2–5 includes three sub-paragraphs. The first two, a. and b., start with the word "Evaluate." Sub-paragraph c. directs the auditor to "[t]est some of the work performed by others to <u>evaluate</u> the quality and effectiveness of their work." [Underscore added.] The auditor must re-perform management's internal control testing under this guidance. It also depends on what the Board's definition of "some" is. Does the Board mean testing management's work only on high risk company-level controls? Is it the Board's intention to limit the auditor's testing to ten percent (10%) or twenty percent (20%) or twenty-five percent (25%)? The Board may not wish to publish such a bright line. The guidance ought to keep the percentage small (10% to 20%) given that there is a concurrent assessment of competence and objectivity.

14. Can the auditor perform an effective audit of internal control without performing an evaluation of the quality of management's process?

If the auditor determines that management's personnel are either not competent or not objective to perform testing, the auditor will have to broaden his or her testing for both audits. To re-perform management's testing regardless of competence and objectivity of management personnel is a colossal waste of time and money.

15. Will an opinion only of the effectiveness of internal control, and not on management's assessment, more clearly communicate the scope and results of the auditor's work?

I believe it will more clearly communicate the scope and results of the auditor's work. The process starts with the auditor determining the controls to test based upon the rubric presented on pages A1–11 to the top of page A1–20 in paragraphs 16 through 46. If the auditor observes that management has selected the same, or as much as ninety percent (90%) of the same controls to test, the auditor has an indication that management's assessment will be consistent with what the auditor now anticipates finding. With the requirement to assess competence and objectivity in place, the auditor ought to have a solid understanding of management's assessment process without repeating it. In actuality, this encourages *management* to hire competent personnel to perform SOX 404 work, and to compensate personnel in a way to enhance objectivity.

<u>**Permitting Consideration of Knowledge Obtained During Previous Audits**</u>

16. Does the proposed standard appropriately incorporate the value of cumulative knowledge?

This proposed standard does appropriately incorporate the value of cumulative knowledge. Benchmarking automated controls will save time for the auditor and management. It will encourage companies to automate as many controls as possible. The Board's inclusion of guidance to the auditors to reflect on prior years' assessment of competency, objectivity, and risk is very helpful. *Can an auditor reduce tests on a high risk control if prior tests are clean without reducing risk to moderate or low?*

17. What are the circumstances in which it would be appropriate for the auditor to rely upon the walkthrough procedures as sufficient evidence of operating effectiveness?

Walkthrough procedures may provide sufficient evidence in highly automated areas, as well as processes with highly effective controls that have not been changed. I advise the Board to include wording to instruct the auditor to test high risk controls in these processes to ensure there was no change. One sample item from the population ought to suffice. In addition, by using acquired knowledge of the client's internal control over financial reporting, simple observation may be sufficient for certain controls. An example of this is general ledger account reconciliation, which follows.

The internal control states that the company reconciles balance sheet and related income statement accounts each month within five days of reporting to corporate headquarters (or small company equivalent, such as the Chief Financial Officer). In the past, the auditor has tested 60 such reconciliation packages and found no exceptions. To reduce time and cost the auditor asks management in writing if there have been any changes or enhancements to this process. Upon receiving the written reply from management that there are no changes or enhancements, the auditor looks at the reconciliation packages for the latest period-end in scope. Past experience guides the auditor in knowing what attributes ought to be observed without asking the client for population and copies of the sample. This will also reduce paper and storage costs. Management will store their documentation for future reference, and this will allow subsequent observation or testing if it ever becomes necessary if the auditor properly documents the items and attributes observed. (The auditor may wish to make one copy of this "sample" to include in the work papers. This is still a dramatic reduction in the amount of paper produced in the audit.)

Refocusing the Multi-location Testing Requirements on Risk Rather than Coverage

18. Will the proposed standard's approach for determining the scope of testing in a multi-location engagement result in more efficient multi-location audits?

The benefits that can be realized with the proposed standard's risk-based approach combined with the proposal on using past experience are numerous. As an example, suppose the auditor obtains the budgets and goals for a large company's various business locations. The auditor sees that a seemingly small office is asked to produce gross profit of forty percent (40%) or more in a given year. This represents a large portion of the overall company's consolidated gross profit. Under AS No. 2's current "coverage approach," audit procedures on financial data and internal control over financial reporting may not have been done for this office. However, the auditor may feel the gross profit percentage to be fairly aggressive. Testing this location seems warranted. In addition, a business location where the local economy has sagged or where a very narrow segment has a high concentration of risk (key customers and/or vendors), more audit attention is needed.

<u>Removing Barriers to Using the Work of Others</u>

19. Is the proposed standard's single framework for using the work of others appropriate for both an integrated audit and an audit of only financial statements? If different frameworks are necessary, how should the Board minimize the barriers to integration that might result?

This question reflects on my comment regarding paragraph 1 on page A2–3 of the proposed standard. The audits ought to be integrated. The only time that this would not occur is when two external audit firms are engaged as referred to in the note to paragraph 1. Specifically, a scenario where one firm audits internal control over financial reporting while a second audits the financial statement. Even here, however, the Board ought to encourage–even require–synergy between the two firms. For example, an agreement as to the level of materiality would have to be in place.

The fewer frameworks put in place, the better for all parties. By building scalability into the replacement for AS No. 2 the Board has addressed many of the fears smaller publicly traded companies face. I believe that most important facet to this process is integration of the two audits, and the Board ought to clearly require it.

20. Does the proposed definition of relevant activities adequately capture the correct scope of activities, including activities that are part of the monitoring component of internal control frameworks?

I believe the proposed definition does capture the correct scope of activities. However, the Board limits itself by stating, "Only tests that provide audit evidence may be considered relevant activities." A walkthrough performed by a competent and objective company employee may permit the auditor to rely upon that work for a low or moderate risk process (where the auditor uses three levels of risk). The auditor may also wish to rely upon flow charts of high risk processes to add to his or her walkthrough documentation.

21. Will requiring the auditor to understand whether relevant activities performed by others identified control deficiencies, fraud, or financial statement misstatements improve audit quality?

I believe it will be helpful, provided those "others" are competent and objective. This can point the auditor towards troubled areas, reducing time spent before fieldwork commences.

22. Is the principal evidence provision that was in AS No. 2 necessary to adequately address the auditor's responsibilities to obtain sufficient evidence?

If the Board truly wants auditors to utilize others' work, the principle evidence provision in paragraph 111 of AS No. 2 must be set aside. The auditor must be permitted to rely upon the evidence derived from others in order for this proposed new standard to work.

23. Does the proposed standard provide an appropriate framework for evaluating the competence and objectivity of the persons performing the testing? Will this framework be sufficient to protect against inappropriate use of the work of others? Will it be too restrictive?

The framework is good, in general. This sentence on page A2–6 in paragraph 13 confuses me: "...[T]he auditor should make judgments about the degree of competence and objectivity of the individuals rather than form an absolute conclusion about whether the individuals are competent and objective." Does the Board intend to remind the auditor that the perception of competence and objectivity may change over time? My comment on introduction paragraph 12 on page 3 of my comment letter provides an example of someone with a degree in English working in an accounting department. Given the guidance in paragraph 13 of this proposed standard, the auditor may at first feel the person has a low level of competence. As testing of controls this person performs progresses–and in light of using what is learned from prior years' work–the auditor may come to believe the person has a higher level of competence. The auditor may also add into the equation the apparent accuracy of the numbers produced by this person. We are still confronted with judgmental terms such as low and high levels.

24. Has the Board identified the right factors for assessing competence and objectivity? Are there other factors the auditor should consider?

The Board has identified the right factors for assessing competence and objectivity. Other factors I recommend are as follows. I believe the Board ought to include a note that those who perform tests may *not* be trained as auditors, nor even have experience in public accounting and auditing. This is acceptable provided these "testers" are first trained and supervised by an individual who is trained as an auditor–a Certified Public Accountant ("CPA") or Certified Internal Auditor ("CIA") with a current license. The external auditor may want to consider if management's "tester" is asked to test a control the auditor would not him or her self ask a junior member of the external audit team to perform. The theory is that the auditor is loath to ask this team member to perform a function, even though that person has taken courses and is preparing for licensure. How competent is management's "tester" by comparison?

25. What will be the practical effect of including, as a factor of objectivity, a company's policies addressing compensation arrangements for individuals performing the testing?

The Board may find it beneficial to include any plan based on company stock as impugning the objectivity whether it is "compensation" or not. This would include a savings plan that may be readily accessed. Conversely, a 401(k) plan that includes company stock may not be accessible until the "tester" reaches a certain age. If it is determined that the "tester" has arranged a loan from the plan, this ought to give pause to the auditor. If management borrows "testers" from within who *do* partake in a stock-based plan of any kind, the auditor may gain comfort if the person specifically hired to manage the SOX 404 project is well compensated in terms of salary *without partaking in*

a stock-based plan, and holds a professional designation as described in my answer to question 24 above. If "testers" are specifically hired for SOX 404 work, they must not partake in stock-based plans.

Recalibrating the Walkthrough Requirements

26. Will requiring a walkthrough only for all significant processes reduce the number and detail of the walkthroughs performed without impairing audit quality?

The Board is attempting to point external auditors towards the top-down, risk-based approach. To this end it is appropriate to guide the auditor to walkthrough the significant processes. This ought to permit the auditor to calibrate his or her initial assessments. The auditor will be able to determine if management has covered all of the financial statement assertions adequately. If the auditor is concerned that another process may be significant afterwards, he or she may look towards management's walkthrough of that process (see my answer to question 27 below).

27. Is it appropriate for the auditor to use others as direct assistance in performing walkthroughs? Should the proposed standard allow the auditor to more broadly use the work of others in performing walkthroughs?

The auditor may be able to utilize the work of an internal auditor and/or a person who is employed to perform SOX 404 compliance for the company. The auditor will assess both the competence and objectivity of those persons. I recommend that the Board stipulate that in order for the external auditor to be able to rely upon the walkthrough the person or persons performing or overseeing the work have a professional designation, such as a CPA or CIA.

Scaling the Audit for Smaller Companies

28. Does the proposed standard on auditing internal control appropriately describe how auditors should scale the audit for the size and complexity of the company?

Yes, the proposed standard does describe how auditors ought to scale the audit based upon a company's size and complexity. Smaller companies may not have either an internal audit department with time to perform SOX 404 testing, or the ability to hire personnel to perform this function. There may be a trade off on the external auditors' opportunity to use the work of others. One wonders if scalability is really a reallocation of focus. The auditor may find that more testing ought to be performed on period-end controls because of lacking of segregation of duties. Furthermore, the overall control environment may be "paternalistic" if the founder of the registered company is heavily involved in day-to-day operations. If this is the case and all decisions pass through this person (or family members) then the auditor may have to increase certain tests to gain comfort with the financial statements and internal controls over financial statement reporting.

29. Are there other attributes of smaller, less-complex companies that the auditor should consider when planning or performing the audit?

One attribute that the Board ought to consider adding to paragraph 10 on page A1–8 of the proposed standard is “corporate governance.” The auditor will have to assess the impact of a Chief Executive Officer who is also Chairman of the Board of Directors. In addition, I recommend that the Board add that the auditor consider if the company’s Board of Directors includes family members and/or persons who have been “promoted” to board member. While reducing work for smaller companies is an admirable goal, it is my belief that greater risk exists in smaller companies.

30. Are there other differences related to internal control at smaller, less-complex companies that the Board should include in the discussion of scaling the audit?

There is an opportunity for the external auditor to adjust the scale of all compliance audits in subsequent years if audit results indicate a healthy internal control environment and test results indicate effectively designed and operating internal controls.

31. Does the discussion of complexity within the section on scalability inappropriately limit the application of the scalability provisions in the proposed standard?

I believe that the Board may do well to address scalability to *all* registrant companies, as I mention in my answer to question 30 above. A large company may have many more effective controls in design and operation than a smaller company. The Board ought to “reward” all companies by guiding external auditors to scale down their procedures as the risk of material misstatement is reduced.

32. Are the market capitalization and revenue thresholds described in the proposed standard meaningful measures of the size of a company for purposes of planning and performing an audit of internal control?

According to the footnote (6) on the bottom of page A1–7 there appears to be an emphasis on “aggregate worldwide market value.” In order to promote comparability from year to year, I recommend that the Board use a threshold based on the *number* of shares issued and outstanding. The other criterion to consider is how many of those shares are actually publicly traded. Market forces may be too volatile to determine audit scale and scope over time.

Proposed Rule 3525 – *Audit Committee Pre-approval of Services Related to Internal Control*

33. Is there other information the auditor should provide the audit committee that would be useful in its pre-approval process for internal control-related services?

The Board’s note inserted after paragraph (b) provides a clear case of where such work is not be permitted. It may be useful to require the auditor’s submission to the audit

committee include the auditor's written discussion why such non-audit service will *not* impair auditor independence. One may also make the argument that this correspondence be mentioned either in management's discussion and analysis ("MD&A"), even though MD&A is not within the scope of SOX 404, or in another disclosure (cash paid to the audit firm for non-audit services, for instance). Ultimately the investing public needs to be protected. Having knowledge that such services are being performed will aid investors in assessing the nature, timing and extent of future cash flows, which is the purpose of financial statements. How much cash is flowing to the external auditor? Is this "fee" enough of an enticement for the auditor to be persuaded in management's favor on significant issues?

Effective Date

34. How can the Board structure the effective date so as to best minimize disruption to on-going audits, but make the greater flexibility in the proposed standards available as early as possible? What factors should the Board consider in making the decision?

While bringing these new standards on line in 2007 would be fantastic, it is impractical because of the impact of tester objectivity. Many companies have stock plans as a benefit. Many persons may have to withdraw from those plans in order for external auditors to place more reliance on management's testing. This will also alter how those of us in SOX compliance are compensated. It would be unwise to offer a "bonus" to SOX compliance personnel to compensate for not being part of the stock-based plan determined by what would have been earned had they been a participating member. Accelerated filers, who are entering year four compliance efforts, will have to make the compensation adjustments. Competent persons will need to be found by smaller companies whose compliance efforts will be commencing in 2007.

This will also impact external audit firms. Firms will have to devise methods for assessing management's work (competence and objectivity), and/or the work of another external firm performing an audit. Each external firm will also have to adjust the audit teams' strategies to fully integrate the audits.

Unless the SEC can approve these standards before June 1, 2007, they ought to become effective for fiscal years ending on or after December 15, 2007.

In closing, an area of concern for both management and external auditors is documentation requirements. We generally copy original documents to include in work papers. With the introduction of software compliance tools, processes, individual controls, test plans, test results, and documents can be stored electronically. The Board may wish to address this technology within these proposed standards.

Respectfully submitted,
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