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

January 15, 2007

PCAOB Rulemaking Docket Matter No. 021:

The purpose of this memo is to provide response to the 34 questions posed by the PCAOB related to the proposed change in AS 2, as well as to provide general feedback on the pending revisions.

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

   No. It is our belief that the top-down approach is not clearly defined. The proposed standard makes reference to a focus on company-level controls and an overall risk-based approach, indicating that you should "begin with financial statement level and company-level controls, and then work down to significant accounts and disclosures, relevant assertions, and significant processes." However, it is not clear how this top-down approach would be applied in practice. Some public accounting firms may not be comfortable eliminating detailed process level controls based solely on risk and the existence of effective company-level controls. Additionally, it is important to note that this top-down risk-based approach is not new guidance. It was first recommended by the PCAOB in the May 16, 2005 Staff Question and Answer. Since this method was first formally documented in May 2005 there have been no noticeable changes in the public accounting firm's approach to identifying and/or testing key controls. Although this guidance is being reiterated in the proposed standard, it seems that in order to ensure that the top-down risk-based methodology is consistently applied across all public accounting firms, further practical guidance is needed.

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

   Yes. It is our belief that there is an appropriate emphasis on the importance of anti-fraud controls.

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

   If the top-down approach is applied consistently it could help to focus the auditor's attention on controls that are perceived to carry the most risk. However, as mentioned in response #1 above, we have not seen any noticeable change in the auditor's focus since the release of the May 16, 2005 guidance. It is our belief that without further practical guidance the risk-based top-down approach will not be consistently applied across all public accounting firms, and *there will be no noticeable change in the auditor's focus. Refer also to the comments outlined in response #1 above.*

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?
   No. Refer to the comments outlined in response #1 above. Although the standard places a clear emphasis on company-level controls by mentioning that the audit should focus on company-level controls and work down to significant accounts, it is not clear how this approach could be carried out in practice. More specific guidance is needed on when the testing of detailed process level controls can be reduced as a result of effective company-level controls. As it stands now, it appears that company-level controls can provide only indirect assurance and will therefore not be sufficient to provide the external auditor comfort at the transaction level.

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?
   It is clear from the standard that controls with lower risk would require a lower level of evidence to support their operating effectiveness. However, acceptable methods of reducing evidence should be clearly defined. For example, if a control is considered low-risk, does this imply that it can be tested solely through inquiry or observation? Additionally, can the overall sample-size be reduced for low-risk controls? Without clear definitions of "low-risk" and "reduced evidence" the standard will not be applied consistently across public accounting firms.

6. Would the performance of a walkthrough be sufficient to test the design and operating effectiveness of some lower risk controls?
   Yes. Performing a walkthrough of the control process one time should provide sufficient evidence that low-risk controls are operating effectively. However, it is also important to note that it is our belief that walkthroughs should only be performed over key controls (not over every type of transaction within each key sub-process). Performing a walkthrough of each key control can be carried out in connection with the testing, and would identify any significant changes in controls from prior years as well as any processes that are not working as intended.

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?
   The revised wording of "significant" appears to be better defined and easier to understand. However, more guidance is needed on how to determine what is "significant" in practice. For example, is "significant" defined in both

qualitative and quantitative terms? If so, what quantitative factor must be used? In the past, any deficiency with a potential impact greater than 1% of interim EBT was required to be classified as significant. It is our belief that the updated guidance should allow for more qualitative factors to be considered in assessing the significance of a deficiency.

8. Are auditors appropriately identifying material weaknesses in the absence of a material misstatement, whether identified by management or the 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?

   Yes. It is our belief that auditors are appropriately measuring material weaknesses based on the potential impact of a deficiency rather than the actual impact.

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?

   No. No changes in guidance were noted that would reduce the level of effort required for evaluating deficiencies. An auditor will still have to post all deficiencies identified, regardless of perceived significance, to the "Summary of Aggregated Deficiencies" and run each deficiency through a framework to formally assess its significance. As such, no reduction in effort is anticipated.

10. Should the standard sallow 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?

    Yes. The presence of a "strong indicator" of a deficiency is not necessarily evidence that a control is not operating effectively. As such, the auditor should be allowed some level of judgment in assessing whether or not a deficiency exists. It is true that incorporating judgment into the process may lead to inconsistency in the evaluation process. However, with uniform guidance for all public accounting firms, the inconsistency should be kept to a minimum.

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

    Yes. Refer to the comments related to the top-down approach outlined in response #1 above. Additionally, note that guidance between external auditors and management needs to be consistent. Specifically, management and the external auditor must use the same approach to selecting key controls and selecting testing methodologies. If they do not use consistent methodologies, companies will not see any benefits from the changes in the SEC guidance as external auditors will increase procedures (thereby increasing cost) if management does not follow the same guidance.

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 on the scope of the audit?

    Yes. The reference to interim statements should be removed from the definitions of significant deficiency and material weakness in order to prevent the auditor from excessive testing. By taking out any reference to interim materiality, the audit would focus on identifying deficiencies within accounts and controls that are significant on an annual basis.

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

    No. The auditor's review of management's testing was never considered time consuming or cumbersome. In fact, the opinion on management's testing effectiveness was somewhat redundant. As such, cutting out the requirement for the auditor to provide this additional opinion will not reduce the overall workload of the auditor.

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

    Yes. As outlined in response #13 above, it is our belief that the opinion on management's testing effectiveness was not needed for the auditor to perform an effective audit of internal control. The procedures performed by the auditor will change very little, if at all, as a result of the elimination of this opinion.

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

    Yes. See responses #13 & #14 above.

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

    Yes. Relying on cumulative audit knowledge and experience should reduce the extent of some of the auditor's procedures. However, it would be helpful to have some examples provided that would outline how cumulative knowledge could lead to an adjustment of testing scope.

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?

    The auditor should rely on walkthrough procedures as sufficient evidence for any control that is classified as "low-risk" in addition to any application controls. However, in order to ensure uniform application of the term "low-risk," further guidance might be required. See also response #5 above.

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?

Yes. At large companies, the standard's approach to scoping using a risk-based methodology should allow for significant efficiencies to be gained. However, at small multi-national companies, the use of quantitative metrics may be one of the easiest ways to distinguish risk among various locations.

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?

    Yes. The standard for using the work of others should be the same regardless of the type of audit being performed. Different frameworks are not necessary and would cause confusion.

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?

    Yes. The definition of relevant activities appears to adequately capture the scope of activities.

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

    No. It is important for the auditor to be aware of and understand any deficiencies identified through the work of others. However, this is not a new step to the audit engagement. Reviewing results of work performed by others (such as internal audit or consultants) was already a requirement on most public accounting engagements. As such, there will be no new improvements to audit quality by making this requirement a part of the standard.

22. Is the principal evidence provision that was in AS 2 necessary to adequately address the auditor's responsibilities to obtain sufficient evidence?

    No. The auditor is already aware that prior to signing the opinion they are required to obtain sufficient evidence to support their opinion. The principal evidence requirement may cause the auditor to feel that they are unable to make full use of the work of others on the integrated audit engagement.

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?

    Yes. The framework for evaluating the competence and objectivity of persons performing testing appears adequate to prevent inappropriate reliance on the work of others. The framework does not appear to be too restrictive in nature.

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

Refer to response #23 above. The factors proposed for assessing competence and objectivity appear appropriate.

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?

    It is important that the auditor consider compensation arrangements when assessing objectivity. However, the factors that would impact a person's objectivity are likely to be contained in an individual's goals and objectives, rather than in a high-level compensation policy. As such, a simple review of overall compensation policies and procedures might not provide the level of detail needed. Instead, it might be necessary for the auditor to perform a more thorough review of each individual's personal performance file. This may be perceived as intrusive to some individuals.

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

    No. It is our belief that, in practice, auditors were already limiting their walkthrough to transactions that would address key controls within significant processes. As such, the revised wording of the standard, which allows the auditor to avoid testing every transaction in every key process, is not a significant change from the current practice – it will not reduce the number of hours required to perform walkthroughs, nor will it change the overall quality of the audit.

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?

    Yes. It is appropriate for "others" to provide direct assistance in performing walkthroughs. However, the benefits gained by using the work of others may be limited depending on who the "others" are. For example, if internal audit or management is used to assist in walkthroughs, both the company and the auditor may gain in both knowledge and efficiency. However, if outside consultants who are unfamiliar with the company or do not have ongoing involvement in the company are used to perform walkthroughs, the benefits gained may be minimal.

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 standard appears to appropriately address ways in which the audit should be modified based on size and complexity. However, the modified requirements for documentation may be confusing to some companies and auditors. For example, if smaller companies are not required to produce formal documentation as evidence of a control's operating effectiveness, how will the auditor prove that a control is operating as stated? Additionally, how will you measure the involvement of senior management in smaller companies? Further practical guidance may be required.

29. Are there other attributes of smaller, less-complex companies that the auditor should consider when planning or performing the audit?
    No. We noted no additional attributes of smaller companies that should be considered in the standard.

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?
    No. We noted no other differences related to internal control at smaller companies that should be considered in the standard.

31. Does the discussion of complexity within the section on scalability inappropriately limit the application of the scalability provisions in the proposed standard?
    While size is easily quantifiable, the discussion of complexity incorporates some degree of judgment into the scalability provision. It will be important for clear guidelines to be to ensure that all auditors interpret complexity in the same way. Clear guidelines on assessing complexity should prevent any inappropriate limitations to the scalability provision.

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?
    The market capitalization and revenue thresholds outlined in the standard do not appear to be consistent with SEC guidance and previous guidance used in assessing the size of companies. Additionally, under the PCAOB definition, several companies that were not previously considered "small" would fall into the category of small, which could cause confusion. PCAOB guidance should be consistent with SEC guidance and previously issued guidance.

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?
    No. We noted no additional information that the auditor should provide to the audit committee in its pre-approval process for internal control-related service.

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 this decision?
    Regardless of the effective date of the standard, early adoption of the standard should be allowed for all companies in their FY 2007 reporting cycle.

Overall, the revised guidance proposed by the PCAOB will, at a minimum, cause both the external auditor and management to perform a re-evaluation of their approach to 404 testing. However, it is important that the PCAOB consider the SEC guidance for management in the proposed revision. For example, page 59 of the SEC's guidance ("Management's Report on Internal Control over Financial Reporting") states that:

> “..The benefits of the proposed amendments may be partially offset if the company’s auditor obtains more evidence directly itself rather than using evidence generated by management’s evaluation process, which could lead to an increase in audit costs.”

The PCAOB guidance should be closely aligned with management’s approach to add efficiencies and reduce any potential cost increases that the auditor would incur by performing more direct testing on its own.

Cassandra Scozzie	Shelly Trochemenko
Internal Audit	Internal Audit
Keithley Instruments, Inc.	Keithley Instruments, Inc.