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February 26, 2007

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

Re: Rulemaking Docket Matter No. 021: **Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and Other Related Proposals**

We respectfully submit our comments on PCAOB Release No. 2006-007 in the role of advisor to our clients as they evaluated the effectiveness of their internal control over financial reporting (ICFR) and formulated an assertion with respect to such ICFR in accordance with The Sarbanes-Oxley Act of 2002, and specifically with Section 404 of the Act. While we are neither a registrant nor an accounting firm, we are offering insight arising from a multitude of experiences as an advisor to hundreds of companies in achieving compliance with Section 404 and/or determining how to improve their compliance processes. In conjunction with these experiences, we have been exposed to all of the major accounting firms.

We support the Public Company Accounting Oversight Board's (PCAOB) efforts to align Auditing Standard No. 2 with the interpretive guidance proposed by the Securities and Exchange Commission (SEC or Commission). We also agree with the overall objective of a top-down, risk-based approach. To that end, we offer the following comments and observations for the Board to consider.

Clarify meaning of "Significant Accounts"

The Board should make it explicit that designating all accounts above a quantitative threshold as "significant" is inconsistent with a risk-based approach. The Board should spell this out as clearly as possible that this is not acceptable practice because it treats every account above the quantitative threshold as equivalent in terms of financial reporting risk. For example, we are concerned that some auditors could read the PCAOB's proposed guidance as saying "quantitative first" and then "qualitative as additive only", meaning consider qualitative factors to add items into scope if they fell below the selected quantitative threshold. We don't agree with that approach, which is currently predominate in practice, because it is inconsistent with a risk-based approach.

If the PCAOB wants to eliminate the above practice, we recommend that the Board include in the new AS5 the explicit guidance in Question 41 of the PCAOB staff questions and answers issued in May 2005, which states: "Paragraph 65 of Auditing Standard No. 2 describes quantitative and qualitative factors that the auditor should evaluate together when determining whether an account is significant. It is important for the auditor to take into account the total mix of information that is available in determining an account is significant. Accordingly, quantitative measures alone are not determinative of whether an account should be identified as significant." That guidance

is crystal clear and we are unsure why the Board didn't include equivalent guidance in the proposal.

Consider the Implications of Auditing in a "Walk-Around" Environment

We recognize the direction the SEC and PCAOB are headed in terms of a scalable audit for small companies without multiple layers of management and multiple business units. We understand the points of view regarding management's daily interaction with the business and the implications of such interaction on the nature and extent of controls documentation. However, it is unclear to us how an auditor can audit in a "walk-around" environment, because the audit tests would be principally limited to inquiry and observation. Accordingly, we have two concerns that are not addressed by the standard:

- First, if a company chooses to rely upon the daily interaction and "walk around" by management, how will this activity be effectively supported by management and independently validated by the auditor?
- Second, both the SEC and PCAOB have clearly stated that more emphasis needs to be placed on controls to prevent fraud – particularly the risk of management override of established processes and controls leading to material financial reporting fraud. It is reasonable to assume that the risk of management override increases in environments where management has more hands-on oversight, responsibility and direct influence. This is the environment in which the auditor must determine whether it is appropriate to rely upon the review and "walk around" of management as a reliable entity-level control. While this point reflects the reality of a small company environment, it nevertheless seems incongruent with the emphasis on sufficient controls to prevent and detect management override and fraud.

In these environments, most auditors would likely expand the scope of the financial statement audit to include extensive substantive tests of account balances with little or no reliance on internal controls. The auditor would probably not rely on the control environment, regardless of management's assessment of that environment. Auditors could be placed in a dilemma of issuing the opinion on ICFR based primarily upon either (a) the lack of evidence that material errors or fraud exist based on a largely substantive testing-based audit of the financial statements or (b) the application of inquiry and observation procedures. We do not believe that inquiry and observation procedures provide a sufficient basis for an opinion on ICFR. We also are concerned that a default conclusion on the effectiveness of the control environment on the basis of a substantive financial statement audit would be potentially misleading. Notwithstanding these concerns, the irony is that a scalable audit of ICFR in a "walk around" environment could very likely involve a combination of inquiry and observation procedures PLUS extensive substantive audit tests as part of the integrated audit. The default nature of the resulting conclusion on ICFR could give rise to a differently articulated opinion than the one currently required by the PCAOB.

We realize that there are initiatives underway by the Committee of Sponsoring Organizations (COSO) and the PCAOB that may shed light on the practical application of a scalable audit. Therefore, it would be premature to suggest actions to address the above points until those efforts are completed. While the Board's guidance in paragraphs 9 through 12 of the proposed standard is a good start, we are not convinced it is sufficient to equip auditors on how to address these environments in a manner that achieves the objective of reducing the disproportionate costs borne by smaller companies. We agree with the PCAOB that additional guidance is needed and that the Board's work with its task force of small company auditors and obtaining further input from smaller companies will help.

Clarify the Auditor's Role in Obtaining an Under-standing of Management's Assessment Process

On page 16 of the PCAOB's release, the Board states:

> Under the proposed standard, an auditor still would need to obtain an understanding of management's process as a starting point to understanding the company's internal control, assessing risk, and determining the extent to which he or she will use the work of others.

We agree with this assertion. However, we cannot find where it is made explicit in the proposed standard. We believe it is important that the auditor obtain this understanding to reduce the risk of a significant disconnect between his or her assessment and management's assessment of ICFR.

Other Comments

Following are additional observations:

Consider use of "most" vs. "majority": The Board should further expand the directive on page A1-7 of the proposed standard that "the auditor should focus the majority of his or her attention on the areas of greatest risk to substantially decrease the opportunity for a material weakness to go undetected." The question arises as to what constitutes a "majority?" Is it 51 percent? If 51 percent is an acceptable interpretation of a "majority", does that mean that 49 percent of the effort can be allocated to areas where there isn't a reasonable possibility of a material weakness going undetected or a potential for material error or management override or fraud? We recommend that the Board's term should be "most" rather than "the majority" to minimize the potential risk to interpret "majority" in a manner that is inconsistent with the Board's intent.

Allow flexibility for auditor reliance on self-assessment results in certain situations: Under the proposed guidance, external auditors will not be able to rely on self assessment results if performed by someone not totally objective of the process under review (i.e., which is typically the manner in which self assessment programs are applied). What if Internal Audit were to perform reviews and reperformance over-testing on a subset of areas in which a self assessment program is applied, with the objective of evaluating the overall quality of the self-assessment program? In low risk areas, we believe that such an approach would justify the auditor's redirecting his or her focus on

areas involving greater risk. We have also seen instances where self-assessment is used in lieu of refresh testing at year-end to roll-forward interim testing.

We suggest that the Board consider lightening the restriction on the auditor's use of self-assessment results. For example, self-assessment might be the basis by which management determines that there has been no change since the prior year in areas involving low risk. The use of self-assessment as a change recognition process should be a factor in considering prior year testing scopes and results when assessing current year risk.

Allow the auditor to exercise judgment in using walkthroughs: The PCAOB proposal does not allow for reduction in the scope of walkthroughs based on past performance or external auditor knowledge of the area. As everyone knows, walkthroughs are most time consuming. In areas that are extensively audited by the auditor annually and, as a result, the audit team is very knowledgeable of the process activities and relevant systems, it is unclear to our clients as to the benefit from a walkthrough other than to ensure there aren't any undocumented changes since the prior year. However, if that is the case, there are less costly and more top-down alternatives to ascertaining whether changes have occurred. Additionally, in those areas that are very low risk and do not change significantly year after year (for example, fixed assets), the value derived from a walkthrough is questionable. It may be helpful for the Board to provide further guidance to allow the external auditor to exercise some judgment in determining the areas in which to perform a walkthrough and the frequency of walkthroughs.

Provide examples of reliance on company-level controls: While the proposal allows for greater reliance by external auditors on company-level controls, this has not been an area of significant reliance by external auditors in the past. Greater clarity on example controls, control requirements (e.g., the evidence standard), and the appropriate linkage to process-level transaction processing controls that would justify the reduction of testing of those controls would help greatly in establishing more traction of the top-down approach in practice. We understand that the COSO Monitoring Project has been organized to provide such examples.

Segregate Section 404 related findings from other findings: As companies apply the top-down, risk-based approach, it is reasonable to expect them to reduce the population of key controls on which they will rely for purposes of evaluating the effectiveness of ICFR. This reduced control set is the direct result of an effective application of a top-down, risk-based approach. This development may lead to situations where the auditor identifies control issues that may not be relevant to the performance of the audit client's population of key controls selected by management for purposes of Section 404 compliance and agreed to by the auditor during the evaluation of controls design effectiveness. We agree that management has a responsibility to review all of the auditor's "management letter" observations and recommendations to ascertain whether those observations and recommendations have Section 404 implications. However, we also believe that it would helpful if auditors clearly delineated

the control issues they identify as part of an integrated audit between (a) control deficiencies pertaining to the key controls relied on by management for Section 404 purposes and (b) deficiencies in other controls. If all of the auditor's findings relating to control issues are grouped together, regardless of their relevance to the audit client's key controls, the auditor's communications to management and the audit committee may create confusion as to the most relevant matters from a Section 404 compliance standpoint.

Reconsider management's need to report all control deficiencies to the external auditor. Paragraph 84(e) of the proposed standard states that management should disclose "to the auditor all deficiencies in the design or operation of internal control over financial reporting identified as part of management's evaluation…" While we agree that management should report all significant deficiencies and material weaknesses to the external auditor, as required by this same paragraph, reporting all control deficiencies could have the unintended consequence of focusing the external auditor on matters that are clearly immaterial to the financial statements and irrelevant to the SEC's goal for the Section 404 evaluation process, which is as follows (from page 13 of the Commission's proposed interpretive guidance):

> [T]he central purpose of the evaluation is to assess whether there is a reasonable possibility of a material misstatement in the financial statements not being prevented or detected on a timely basis by the company's ICFR.

As an alternative, the external auditors could inquire of management whether there were any control deficiencies that were particularly difficult to classify as a significant deficiency versus a control deficiency.

We appreciate the opportunity to submit our comments and feedback. We hope they are helpful to the Board and to its staff. If the staff would like to discuss any of the points made in this letter, please contact Jim DeLoach at (713) 314-4981.

Very truly yours,

By: James W. DeLoach, Jr.
Managing Director