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February 26, 2007

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

Via e-mail: comments@pcaobus.org

Re: PCAOB 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 Related Other Proposals*

Dear Board Members and Staff,

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's ("Board" or "PCAOB") proposed new auditing standard, *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements,* (the "proposed standard", or "proposed AS5"). We respectfully submit, in Appendix A, our responses to your questions. Additional comments and suggestions are presented in Appendix B and C.

We are generally supportive of the PCAOB's proposals; however, we have two significant concerns:

1. The tone of the proposed standard appears to establish efficiency as an auditing standard. We recognize the need to perform audits that are both efficient and effective; however, efficiency should not be a factor in determining whether the auditor performed sufficient audit procedures, or whether the auditor has complied with PCAOB standards.

2. The new proposed standard, *Considering and Using the Work of Others in an Audit,* may be interpreted by some to remove auditor judgment from necessary determinations regarding this subject. We believe it is important for the auditor to be able to exercise judgment related to the use of the work of others. The existing auditing standard related to this topic—namely AU Section 322—is well understood by auditors and has operated effectively since its adoption in 1991. Accordingly, while the related guidance in the proposed AS5 is useful, we do not believe a new auditing standard covering the use of the work of others is necessary.

We would be pleased to discuss our comments with you. If you have any questions, please contact Mr. John L. Archambault, Managing Partner of Professional Standards, at (312) 602-8701, or Mr. R. Trent Gazzaway, Managing Partner of Corporate Governance, at
(704) 632-6834.

Very truly yours,

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Appendix A – Responses to Questions

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

   Except as otherwise expressed herein, the proposed standard clearly articulates the need to use a top-down, risk-based approach to auditing internal control over financial reporting (ICFR). In addition, the proposed standard provides useful factors to consider in conducting such an audit. However, it is important to note that the variables influencing a top-down, risk-based approach are highly judgmental in nature and will vary from company to company. In addition, the top-down, risk-based approach will become more refined as auditors, as well as management, perform more evaluations of ICFR.

   The goal of encouraging auditors to use more judgment in their audits is laudable; however, the goal should not be achieved at the expense of audit quality. Additional guidance regarding how to apply judgment in a top-down, risk-based approach would help the consistency and quality of audits. The guidance could incorporate some of the concepts that currently exist in Auditing Standard (AS) No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, but have been removed from the proposed standard. The guidance could also incorporate much of the valuable guidance contained in the PCAOB Staff Question and Answer documents which may not already be incorporated into the proposed standard.

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

   The proposed standard does place appropriate emphasis on the importance of identifying and testing controls designed to prevent or detect fraud ("fraud controls"). As referenced in the proposed standard, this same emphasis is included in AU Section 316, *Consideration of Fraud in a Financial Statement Audit*.

   Paragraph 44 of AU Section 316 provides some guidance on the types of fraud controls, which include (a) specific controls designed to mitigate particular risks of fraud, such as controls to address certain assets susceptible to misappropriation, and (b) broader programs designed to prevent, deter and detect fraud, such as programs to promote a culture of honesty and ethical behavior. The final standard should be clear as to what constitutes fraud controls that should be covered by the evaluation of ICFR. It is our experience that nearly all controls have some role in the prevention or detection of fraud; however, there are very few controls that are specifically designed to prevent or detect fraud. Yet the words and prominence given to the concept of fraud controls in the proposed standard makes one believe there are many such controls.

   In addition, we believe it would be helpful to clearly articulate that the primary responsibility for the deterrence and detection of fraud rests with management, the audit committee and the board of directors.

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

   A top-down, risk-based approach, if properly and consistently applied, will appropriately focus the auditor's attention on the most important controls. However, as indicated in our response to the following question, the practical application of the concept of a "top-down, risk-based approach" is not consistently understood in the marketplace today. Many people believe the concept refers to the near-exclusive reliance on certain company-level controls—namely the monitoring of the results of operations and self-assessment activities. Both of these elements are important to an effective system of internal control; however, they rarely form adequate support on their own for management's or the auditor's conclusions regarding the effectiveness of ICFR.

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?

The proposed standard properly highlights the importance of company-level controls and their potential effect on the auditor's work. However, our experience has shown that companies rarely have company-level controls that operate at a sufficient level of precision to cause the auditor to reduce testing at the process level.

Page 6 of the release states: "In a top-down approach, if company-level controls are strong and link directly to the process-level controls, or if they are sufficiently precise to prevent or detect material misstatements to relevant assertions, the auditor will likely be able to reduce the testing of controls at the process level." The proposed standard should more clearly articulate what constitutes "link directly," "strong" and "sufficiently precise." Examples of company-level controls that do and do not meet those expectations should also be provided in the form of guidance.

As noted in our response to Question No. 3, many believe the term "company-level controls" refers to the near-exclusive reliance on controls to monitor results of operations and self-assessment activities. Monitoring the results of operations can sometimes indicate if a significant problem has occurred, but it cannot normally, on its own, provide reasonable assurance that such a problem could not occur and remain undetected. Likewise, self-assessments establish accountability and provide some evidence that controls are operating as intended, but they lack the necessary objectivity to provide all the support necessary over long periods of time. In reality, both elements more effectively provide interim support for a conclusion regarding control effectiveness between periodic, separate control evaluations. The length of time between, and the intensity of, these separate evaluations will be dependent on the level of risk and the strength of the evidence gathered during the interim periods.

Both the PCAOB and the SEC should clarify the benefits and limits of company-level controls in forming an opinion about the effectiveness of a system of internal control over financial reporting—recognizing that many risks are manifest at the transaction level and must be both controlled and evaluated at that level. To the extent that management effectively monitors important internal controls (consistent with the intent of the monitoring component of the COSO Framework[1]), those procedures may be the primary controls the auditor determines should be tested in connection with the audit of ICFR. This determination should be based on an appropriate 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?

The proposed standard appropriately highlights the importance of risk assessment and the relationship between risk and the evidence necessary to support an audit opinion. However, there is presently a lack of effective guidance, both in the proposed standard and in the marketplace, to support a consistently applied risk assessment methodology.

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[1] "COSO Framework" refers to the Committee of Sponsoring Organizations of the Treadway Commission's *Internal Control – Integrated Framework* issued in 1992.

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

   When the risk that a material weakness could exist in a particular area is assessed as unlikely, we agree that a walkthrough could be an appropriate response to the identified risk without further work. However, the term "lower-risk controls" will create confusion in some cases.

   The term "lower-risk controls" is different for an audit of internal control versus a financial statement audit. In an audit of internal control, as the risk associated with a control decreases, the evidence to be obtained also decreases (paragraph 51 of the proposed standard). In an audit of financial statements, however, the lower the assessed control risk, the more testing would be required to support the control risk assessment. Obviously, "low control risk" differs from "lower-risk controls"; however, the potential for confusion remains.

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 term "significant" is generally understood, but still is not sufficiently defined to ensure that its use in practice will be consistent. Absent additional guidance, the change in the definition is very likely to increase the debate and tension between auditors and management regarding the classification of certain deficiencies, and will create a perception that the bar has been raised, when we understand such is not the intent. Further, we are not convinced that evaluations by auditors using the current terminology have been at a lower threshold than the Board intended. Stated differently, we believe that items previously reported as significant deficiencies would, and should, remain significant deficiencies under the proposed definition.

   We suggest maintaining the existing definition and incorporating the guidance on this matter from the Staff Questions and Answers, which was helpful in clarifying the appropriate "threshold." The PCAOB could also define "more than inconsequential" in much the way it has defined a significant misstatement: "A misstatement that is more than inconsequential is a misstatement that is less than material yet important enough to merit the attention by those responsible for oversight of the company's financial reporting." This would be consistent with the term's current interpretation.

8. Are auditors appropriately identifying material weaknesses in the absence of an actual 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?

   Some commenters have concluded that too many material weaknesses are identified only after a problem has occurred, rather than before. These conclusions are generally based on analyses of the number of companies disclosing material weaknesses at the same time they disclose a restatement. However, it is important to note that the financial reporting profession, including the auditing profession, is still in the relatively early stages of assessing and auditing ICFR. The increased focus on the quality of the financial reporting process over the last few years has resulted in both the identification of material weaknesses and the identification of necessary restatements. As both companies and auditors become more adept at evaluating ICFR, we believe restatements will decline, and their respective abilities to proactively identify material weaknesses will increase, as will the efficiency with which they do so.

   Further, the design and evaluation of internal control is based on reasonable assurance, not absolute assurance. The nature and extent of misstatements that could occur are virtually endless. Thus, a proper assessment of what reasonably could be misstated, how it could be misstated, and whether the identified controls would be effective leave open the possibility that material misstatements will occur even in companies for which controls are well designed and operating at a level of reasonable assurance.

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?

   Except as previously indicated with regard to using the term "significant" in lieu of "more than inconsequential," the proposed changes to the definitions of significant deficiency and material weakness will improve the communication of deficiencies between auditors and management. This fact alone will improve the efficiency of the audit process. However, there must be a mutual understanding that the proposed changes will not dramatically affect the audit methodologies and scopes of auditors who previously interpreted the related definitions in accordance with the Staff Questions and Answers.

   The proposed change from the term "more than remote likelihood" to "reasonable possibility" merely formalizes guidance previously issued by the PCAOB[2]. Accordingly, any auditor that correctly interpreted the term "more the remote likelihood" will apply that same definition under the proposed standard.

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?

    The standard should allow that no material weakness exists when one of the strong indicators is present. We are not aware of any instances in which the presence of a strong indicator does not indicate at least a control deficiency. The strong indicators of significant deficiencies and material weaknesses present in AS No. 2 and the proposed standard provide consistency in the analysis and communication of some of the most significant forms of control deficiencies. It is important to recognize that there are rare instances in which these indicators may exist, and yet a reasonable person would conclude that no material weakness in fact exists. We agree with allowing judgment based on the circumstances of the engagement, but we believe the proposed standard should be clear that—when a "strong indicator" of a material weakness is present—there is a rebuttable presumption that a material weakness is present.

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

    Auditors should be able to apply the guidance provided in the proposed standard to achieve an effective audit while avoiding unnecessary testing. We would like to note, however, that throughout the proposed standard, there are requirements that seem to be based on the efficiency of the audit rather than its effectiveness. Although efficiency is necessary, it should not be a factor in determining whether the auditor performed sufficient audit procedures or whether the auditor has complied with PCAOB standards. Accordingly, we urge the Board to reconsider the use of the words "should" and "must" for appropriateness and necessity throughout the proposed standard where such terms might imply that the auditor should sacrifice necessary audit quality for the sake of efficiency.

    It is also worth noting that the success of improving efficiency while maintaining audit quality will occur only if the inspection process is consistent with the concepts in the proposed standard.

[2] See the November 30, 2005, PCAOB Report on AS2 Implementation, page 4.

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?

The reference to interim financial statements should be removed from the definition. The requirement under the Sarbanes-Oxley Act of 2002 ("SOX") is that management make an assertion, and that the external auditor audit, whether internal control over financial reporting is effective as of a specific day each year—the end of the most recent fiscal year of the issuer. The reference to the impact of deficiencies on interim financial statements is both confusing and inconsistent with the law.

While AICPA attestation standards in effect at the passage of SOX and the issuance of AS No. 2 allow for the option of reporting on controls that were in place during a specified period or on a specified date, the drafters of the law and standard clearly opted for the latter option. References to interim reporting suggest that the financial reporting process for interim financial statements is working at fiscal year-end, that interim financial statements are being prepared and filed with the U.S. Securities and Exchange Commission ("SEC") at fiscal year-end, and that the internal control over preparation of interim financial statements is in operation and subject to testing at fiscal year-end, when none of these things is true.

The removal of the reference to interim financial statements will improve the efficiency of communications between management and auditors regarding control deficiencies, but it will not impact the scope of the audit. Question #32 of the PCAOB's November 22, 2004, *Staff Question and Answer* document has already clarified that the reference to interim periods in the definition of significant deficiency and material weakness does not have any effect on either the scope or timing of the auditor's procedures in an audit of internal control over financial reporting.

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

We understand that some auditors were performing detailed testing solely to conclude on management's assessment process, with the assumption that the auditor's opinion related to management's process, not its assessment (or assertion). To the extent that auditors were conducting unnecessary tests on management's process under AS No. 2, the proposed revision will eliminate unnecessary audit work. However, we believe most auditors did not perform unnecessary testing on management's process and will not be eliminating audit work as a result of this specific change.

Further, the auditor must evaluate and test management's monitoring of controls in his or her audit of ICFR. Therefore, while an ineffective management process for assessing ICFR may no longer result in a disclaimer of opinion, the PCAOB (and the SEC) should clarify that an ineffective monitoring of controls would be a strong indicator that one or more material weaknesses in ICFR exist.

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

See our response to Question No. 13 above.

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?

We believe the existing opinion clearly articulates the results and scope of the auditor's work by expressing an opinion directly on the effectiveness of internal control and expressing an opinion on management's assessment (or assertion) about internal control effectiveness. The primary vehicle through which auditors formed an opinion on management's assessment was their audit of ICFR.

We acknowledge, however, that the revision to the reporting model will assist the individuals that previously misinterpreted the opinion on management's assessment.

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

    The proposed standard does appropriately incorporate the value of cumulative knowledge. We agree with incorporating the guidance on benchmarking for automated application controls, which we believe has provided, and will continue to provide, for an effective and efficient audit.

    It would be helpful, however, to clarify the guidance in paragraph 67 of the proposed standard, which states, "After taking into account the risk factors identified in paragraphs 52 and 66, the lower the risk associated with a control, the less evidence that the auditor needs to obtain in the subsequent year's audits." We believe this statement may be interpreted to permit rotational testing based on the assumption that controls were effective in the prior year, which would represent indirect reliance on the design and operating effectiveness of controls in prior years. If that is the PCAOB's intent, it should be clarified.

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?

    See our response to Question No. 6 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?

    We have previously commented on the need to modify the multi-location testing requirements, particularly relative to organizations that have a large number of homogeneous locations. Although the proposed standard allows for an appropriate risk-based focus on testing, the implications of eliminating completely the concept of coverage could have very serious negative consequences. The concept of coverage is fundamental to the evaluation of ICFR effectiveness. Other than Appendix B of AS No. 2, no guidance exists in this area.

    Some may interpret the PCAOB's position on this matter as allowing an auditor to test locations representing less than 50% of a company's consolidated financial statements. Such an approach may be appropriate in limited circumstances, such as with an organization with a large number of homogeneous locations, but those instances would be rare. The proposed standard should make it clear that the auditor is responsible for conducting an audit of sufficient scope, and that coverage is often an appropriate consideration in the risk assessment process. It would also be helpful to incorporate, as guidance, the concepts in AS No. 2.

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?

    Although a single framework for using the work of others could be appropriate for both an integrated audit and an audit of only financial statements, we do not believe the proposed standard, *Considering and Using the Work of Others in an Audit,* is necessary. Our specific concerns are expressed below and in our responses to Questions No. 20 to No. 25.

    Existing AU Section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, recognizes that, in accordance with The Institute of Internal Auditors'

Standards for the Professional Practice of Internal Auditing, internal auditing is an independent appraisal function that requires internal auditors to be independent of the activities they audit. In an integrated audit and an audit of only financial statements, AU Section 322 and the proposed standard are appropriate and clear.

However, the proposed standard expands the auditor's considerations to using the work of other company personnel, as well as third parties working under the direction of management or the audit committee. Ordinarily, such third parties represent members of the accounting and auditing profession, and they also adhere to certain professional and ethical standards relating to objectivity. Accordingly, the use of their work would be appropriate, mostly as it relates to ICFR. With regard to non-internal audit company personnel, however, it may be very difficult for the auditor to overcome the hurdle of objectivity. For such individuals, it would be helpful to clarify that this would include company personnel that perform functions similar to those of internal audit and that it would not include the work of non-internal audit company personnel performed in the ordinarily course of business.

Although AS No. 2 currently allows for the use of the work of others, which includes non-internal audit company personnel and third parties, we believe the standard has been broadened to not only consider their work as it relates to ICFR, but also their work as it relates to evidence (not direct evidence, as indicated in our response to Question No. 21) about potential misstatements. This broadening of the standard—combined with the removal of the principal evidence provision—could result in inappropriate use of the work of others, resulting in an ineffective audit. We believe it is important for the auditor to be able to exercise judgment related to the use of the work of others.

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?

The proposed definition of "relevant activities" is, for the most part, consistent with the description of relevant activities in AU Section 322 and, therefore, should be understood consistently by auditors. However, based on this question, the PCAOB's intent is unclear with regard to whether the definition encompasses activities that are part of the monitoring component of internal control. As indicated in our response to Question No. 4, many people believe that the monitoring component of internal control is limited to reviewing the results of operations and monitoring self-assessments. More guidance is needed in this area to better define what effective monitoring is, and how the auditor might use the work of others who perform effective monitoring.

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

Requiring the auditor to understand whether relevant activities performed by others identified control deficiencies, fraud or financial statement misstatements is appropriate and consistent with current practice. Such information assists the auditor in performing risk assessments and other audit procedures. However, the proposed definition modifies the level of evidence that AU Section 322 indicates a "relevant activity" would need to provide related to potential misstatements. AU Section 322.07 indicates that such activities provide "direct evidence" about potential misstatements, while the proposed standard only indicates the need for a relevant activity to provide "evidence." If the difference is intentional, the proposed standard should indicate the intended impact. If the difference is unintentional, the proposed standard should be conformed to the AU Section 322 definition.

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

    The principal evidence provision in AS No. 2 formally stated a concept that has always been true in auditing: namely, that the auditor's own work should form the primary basis for his or her opinion. This is similar to the concept in AU Section 543, *Part of Audit Performed by Other Independent Auditors*, where the auditor determines whether his or her own participation in the audit is sufficient to enable him or her to serve as the principal auditor and to report on the financial statements.

    We understand that the "principal evidence" language was removed out of concern that, as a result of its presence in AS No. 2, some auditors were not using enough of the work of others. However, elimination of the words implies elimination of the concept. Some companies may believe that the auditor could and should use much more, even a majority, of the work of others than what would be permitted under professional standards to support both the financial statement and internal control opinions.

    Accordingly, removing this language will cause additional tension and misperception in the marketplace. Although this exact language need not be used, the concept should be clear that, because the auditor is solely responsible for his or her opinion, his or her own work must be sufficient to enable him or her to report on the financial statements and on internal control. We believe the best approach in avoiding confusion is to retain the principal evidence provision that is in AS No. 2.

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 proposed standard provides an appropriate framework for evaluating the competence and objectivity of others. The proposed standard should also highlight that the substance of objectivity is often more important than the form. For example, a director of internal audit may report functionally to the audit committee, but may be significantly restricted in substance by management in terms of his or her ability to operate freely and properly. Conversely, an internal audit director may report functionally to the chief financial officer, yet have open and frequent access to the audit committee and have the necessary autonomy to properly perform internal audit duties. The proposed standard should highlight the importance of these judgments.

    Further, the guidance on evaluating objectivity is even more important with regard to company personnel (other than internal audit). It may help to provide an example of these individuals and how the auditor might deem them to be objective.

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

    See our response to Question No. 23.

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?

    How individuals are compensated often has a direct bearing on their objectivity. For example, it would be inappropriate for internal audit personnel to have a significant portion of their compensation linked to stock options or stock price. It is therefore appropriate to include compensation arrangements as a factor in evaluating objectivity, as long as allowances are made for reasonable compensation.

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

    Walkthroughs provide the auditor with audit evidence to support his or her understanding of the process flow of transactions, the design of controls, and whether controls are in operation. Accordingly, it is appropriate to require a walkthrough only for all significant processes instead of for each major class of transactions. We believe this will reduce the number of walkthroughs, without impairing audit quality. It will not, and should not, impact the detail of walkthroughs that are performed.

    We suggest, however, that the proposed standard incorporate, as guidance, the inquiries in AS No. 2 that could be performed during walkthrough procedures. This guidance would help maintain the quality of the walkthrough procedures.

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?

    It is appropriate for the auditor to use others, such as internal audit or a similar compliance function, as direct assistance in performing walkthroughs as long as those individuals are competent, objective and directly supervised by the auditor.

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?

    Paragraphs 9 through 12 of the proposed standard provide helpful guidance on matters relating to size and complexity that would ordinarily impact the auditor's risk assessments, overall audit strategy, and audit procedures to address specific risks. However, the tone of this guidance appears to favor less audit work for smaller companies rather than for companies with less risk. It is not always the case that smaller companies pose less risk, and in many instances, smaller companies pose greater risks.

    Much of the guidance provided in these paragraphs could be equally applied to companies of all sizes and complexities. The matters discussed might have a pervasive effect on the audit or might impact only a particular area of the audit. It is critical that the proposed standard be revised to reflect this and also to focus on effectiveness rather than efficiency. Accordingly, we recommend removing the references (in paragraph 9 and in footnote 6 of the proposed standard) to the SEC's Advisory Committee on Smaller Public Companies' final report, which sets potentially unrealistic expectations regarding the audit effort required for companies of specific sizes.

    We believe an audit guide would be the most appropriate form of guidance to discuss specific matters relating to size and complexity. An audit standard should contain only the basic principles for performing an effective audit. The top-down, risk-based approach is the basic principle that encompasses the concepts of size and complexity. This would be similar to the approach used by COSO. The COSO Framework contains the basic principles; the COSO Guidance for Smaller Public Companies then drills down on the application of the basic principles.

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

    See our response to Question No. 28 above.

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?

    See our response to Question No. 28 above.

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

    It is important that companies and auditors recognize that small is not necessarily equivalent to being low-risk. Small companies that enter into complex transactions must be prepared to account for them correctly. Likewise, the auditor needs to appropriately consider the element of complexity in his or her risk assessment process.

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?

    Establishing any set of thresholds for measuring the size of a company can never capture all the variables that might reasonably impact the auditor's methodology and the risks associated with the particular company. Over-emphasis of the threshold runs the risk of implying that the auditor should dramatically change the scope of his or her audit based on the tripping of some artificial triggers. Auditors should be encouraged to strongly consider such factors as market capitalization and total revenue in their risk assessments, but the establishment of a set of cutoff points will only add confusion to the risk assessment process. Therefore, as noted in our response to Question No. 28 above, we believe those references should be removed from the proposed standard.

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 proposed standard provides an effective list of information the auditor should provide to the audit committee during the pre-approval process.

34. How can the Board structure the effective date so as to best minimize disruption to ongoing 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?

    For the most part, the proposed standard incorporates previously issued guidance, which has already been adopted in many audit methodologies. Most audit firms have already completed modifications to their audit software, methodologies and training in preparation for the 2007 audit year. While it may be possible for some non-technical changes to be made at this point, such as the increased allowance for the use of the work of others, other changes may take more time. As such, it would be appropriate to make the final standards effective for audits of fiscal years ending on or after June 30, 2008, with early adoption permitted.

Appendix B – Specific Paragraph-level Comments

The following describes additional concerns and offers other comments and suggestions relating to specific paragraphs.

- **Paragraph 3 –** The last sentence of this paragraph indirectly implies that the auditor does not need to perform tests of controls himself or herself and could simply use the work of others to obtain evidence. Accordingly, in this sentence, we suggest replacing the "or" with an "and." In addition, we suggest deleting the word "only" in the Note to this paragraph. This term relates to audit efficiency, not effectiveness. It also causes confusion with regard to procedures performed for areas of low risk. Further, it is inconsistent with the language in paragraph 41.

- **Paragraphs 21 and 22 –** These paragraphs also refer to quarterly financial statements. We suggest the Board clarify the auditor's requirements in this area.

- **Paragraph 24 –** We do not agree with the Board's use of such phrases as "should start" in an auditing standard, as they go to efficiency and audit methodology and do not relate to the basic principles governing an audit.

- **Paragraph 58 –** This paragraph states, "The auditor's testing of the operating effectiveness of controls should occur at the time the controls are operating." We believe this should be revised, as it imposes a requirement to only test operating effectiveness when the controls are operating. Operating effectiveness could be tested at other times, provided there is documentary evidence of the control operation.

- **Paragraph 87 –** We suggest clarifying the Board's intent with regard to the use of the phrase "prior to the issuance of the auditor's report." To eliminate confusion, we suggest the Board use phrases such as "prior to the report date" or "prior to the report release date," as these terms are better understood in current practice.

- **Paragraph 94(c) –** It is unclear as to what is meant by an "identification of management's assessment" and how that differs from the language in (b), an "identification of management's conclusion." We believe the former might refer to the scope of internal control over financial reporting covered by management's assessment. However, some clarification on this point would be helpful.

- **Other –** As indicated in our letter, there are many requirements dealing with efficiency rather than effectiveness. In addition, there are certain other requirements that appear to be statements of fact rather than auditor actions. The specific paragraphs on which we believe the Board should focus for appropriateness include: paragraphs 8, 9, 10, 11, 12, 25, 27, 43, 56, 75, and B14. These paragraphs include matters that may be duplicated in, or covered by, other requirements. When considering these paragraphs, we urge the Board to consider the relationship to the documentation requirements in AS No. 3, *Audit Documentation*.

Appendix C – Other Recommendations

The following represent other recommendations. Unless otherwise indicated, suggested new language is shown in boldface; double strikethroughs suggest deletions.

- **Paragraph 7 –** We suggest the following revisions: "The audit of internal control over financial reporting ~~should~~ **must** be integrated with the audit of the financial statements. The objectives of the audits are not identical; however, ~~and~~ the auditor ~~must~~ **should** plan and perform the work to achieve the objectives of both audits."

- **Paragraph 17 –** We suggest the following revisions: **"**The auditor's evaluation of company-level controls can result in increasing or decreasing the testing that the auditor ~~otherwise would have performed~~ **performs** on controls at the process, transaction, or application levels."

- **Paragraph 30 –** Because this is a requirement, we suggest adding a footnote that would permit the auditor to use assertions that are similar to those listed. Certain auditors may have adopted the expanded list of assertions developed by the International Auditing and Assurance Standards Board and the Auditing Standards Board of the American Institute of Certified Public Accountants.

- **Paragraphs 47 and 48 –** In the first sentence of each of these paragraphs, we suggest replacing the word "test" with the word "evaluate."

- **Paragraph 51 –** In the first sentence, we suggest replacing the phrase "would result" with the term "exists."

- **Paragraph 62 (1st bullet) –** We suggest replacing the phrase "must be" with the word "are."

- **Paragraph 76 –** Compensating controls may or may not have been tested by the auditor. It would be helpful to clarify the auditor's requirements for testing compensating controls when trying to rule out whether the deficiency is a significant deficiency or a material weakness.

- **Paragraph 84(f) –** The audit of internal control over financial reporting is integrated with the audit of the financial statements. Accordingly, the representations regarding fraud should be consistent. Please consider whether modifications should be made to this paragraph or AU Section 333, *Management Representations.*

- **Paragraph 102 –** We believe the reference in the Note to paragraph 100 should be to paragraph 97 instead.

- **Paragraph 103 –** We believe the Note that is included in paragraph 102 would also apply to this paragraph.

- **Paragraph B4 –** We recommend conforming the second sentence to the first sentence in paragraph 3.

- **Paragraph B11 –** We suggest clarifying the auditor's requirement in the last sentence. The phrase "should inform" is unclear.