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Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
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 Related Other Proposals***

Dear Members and Staff of the Public Company Accounting Oversight Board:

BDO Seidman, LLP welcomes this opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB" or "Board") proposals: *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, that would supersede Auditing Standard No. 2 ("AS 2"), and related other proposals.

BDO supports the efforts of the PCAOB to increase efficiencies in the implementation of an audit of internal control over financial reporting ("ICFR") while maintaining its effectiveness. We recognize that a methodology that integrates the audits of the financial statements and ICFR and balances benefits and costs is essential for the successful implementation of ICFR audits. The current proposals, while introducing new guidance in some areas, in many ways serve to clarify and consolidate previously issued guidance into one standard, which we believe should assist in implementation.

While we support the principles based approach provided for in the proposed standard, we also believe that an increase in the number of examples presented and clarification of some of the more complex issues will help ensure consistent application. For example, we suggest that the proposed standard retain examples about how to evaluate the significance of internal control deficiencies in various situations and examples of controls designed to address fraud.

During the initial implementation of AS 2, the effort expended to implement the standard vastly exceeded expectations. This was due to a number of factors, including a tight implementation time frame. As a result, the learning curve was steep for both management and auditors. As auditors and registrants have gained experience over the past two years in performing ICFR audits, and are better able to implement a top-down, risk-based approach, efficiencies are being realized.

Now in the third year of implementation, we believe that ICFR audits have become further integrated with the financial statement audit, and that auditors generally are now taking a risk-based audit approach to the integrated audit, except where limited by specific provisions within AS 2.

While we generally support the proposed standard and other related proposals, we have provided suggestions in response to the specific questions below that we believe would improve implementation. Further, we have added additional commentary, at the end of this letter, on other matters that we believe merit attention.

Focusing the Audit on the Matters Most Important to Internal Control

- 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 top-down approach is an essential element impacting overall audit efficiency. The description of the top-down approach, where the auditor first looks at the financial statement level and company-level controls in place, and then moves sequentially down to significant accounts and disclosures, relevant assertions, and significant procedures, could be enhanced by the inclusion of the table that is presented in the PCAOB's May 16, 2005, Staff Q&A 38. While the approach is described in the text of the proposed standard, an illustration of the sequence of steps, including examples of the timing and nature of procedures appropriate at each step in the process, would promote efficiency in implementation.

   We also believe that it would be helpful to include more detailed discussion of the different types of company-level controls, and how some company-level controls have a closer relationship than others to specific financial reporting assertions and related control activities and thereby have a greater impact on the top-down approach. Also refer to our response below to question four.

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 addresses the auditor's consideration of fraud as part of the evaluation of the control environment in the implementation of the top-down approach (paragraph 20) and also as a factor to consider in identifying significant accounts and disclosures and in selecting controls to test (paragraphs 26 and 45). Footnote references to AU section 316, *Consideration of Fraud in a Financial Statement Audit,* are provided for additional guidance. However, we recommend that in addition to including footnote references, important concepts also should be emphasized and stated in the standard; for example, it may be useful to list the fraud risk factors that relate to (1) fraudulent financial reporting, and (2) misappropriation of assets and how the auditor's response to the assessment of the risk of material misstatement due to fraud is influenced by such risk factors.

Paragraph 20 of the proposed standard includes matters the auditor should assess as part of the evaluation of the control environment, including "whether the company takes actions to reduce or mitigate the incentives and pressures on management that would provide a reason to misstate the company's financial statements." We suggest that this matter be clarified by providing examples of the types of company actions the auditor should assess.

We also believe that fraud considerations should be emphasized throughout the proposed standard, starting with risk assessment, rather than as a separate section. Specifically, we suggest including fraud considerations earlier in the standard, starting with the discussion on identification of company-level controls that starts at paragraph 17, in order to better integrate the auditor's consideration of fraud, consistent with the provisions of AU section 316, *Consideration of Fraud in a Financial Statement Audit.*

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

We believe that the top-down approach is essential to identifying the most important controls, first at the company-level and then at the transaction level. Based on our experience in implementing the top-down approach within the integrated audit, this approach is necessary to focus engagement teams during planning and throughout the audit on the most important controls, those that mitigate the risk of material misstatement. The assessment of the control environment and the controls that operate at that level have a pervasive effect on controls that operate at the transaction level and, as a result, any assessment of controls operating at that lower level cannot be performed effectively without an understanding of those higher level controls.

For example, when company-level controls such as monitoring controls are operating effectively, with the appropriate degree of precision, testing at the lower level can ordinarily be reduced. However, if company-level controls are not operating effectively, this will generally result in more rigorous testing at the lower level.

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?**

AS 2, paragraph 54, states that, "Testing company-level controls alone is not sufficient for the purpose of expressing an opinion on the effectiveness of a company's internal control over financial reporting." This provision of AS 2 prohibited reliance on company-level controls alone to address the risk of material misstatement, under the presumption that it would be difficult for controls that operated at such a high level to operate at a level of precision necessary to prevent or detect material misstatements to individual relevant assertions. Under AS 2, the effectiveness of company-level controls impacts the nature, timing and extent of work performed at the more detailed level, but some additional testing at the lower level is always required.

The proposed standard now omits this provision, and instead paragraph 43 states, "…the auditor should recognize that company-level controls vary in precision. Some company-level controls are designed to operate at the process, transaction, or application level and might adequately prevent or detect, on a timely basis, misstatements to one or more relevant assertions." This provision effectively eliminates the absolute prohibition of the use of company-level controls <u>alone</u> to address the risk of material misstatements to individual relevant assertions. However, we believe that many company-level controls only indirectly relate to relevant assertions and often do not operate at a sufficient level of precision to address the risk of material misstatement at the individual relevant assertion level.

To better communicate how company-level controls could operate at an acceptable level of precision, further guidance and examples should be presented, including examples about the effectiveness of company-level controls in adequately addressing the risk of fraud. Additional examples that demonstrate when company-level controls would be expected to operate at a level of precision to adequately prevent or detect material misstatements on a timely basis at the individual assertion level, contrasted with those company-level controls that would not operate at such a level, should be presented to emphasize the characteristics of the controls and circumstances that lead to one conclusion versus the other.

Without these examples, we believe that some auditors may not take appropriate credit for tests of certain company-level controls that are operating effectively. Conversely, there is also a risk of over-reliance on other company-level controls that, even if operating effectively, would have little direct bearing on accurate reporting of relevant assertions.

- 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?

The proposed standard appropriately recognizes that there is a relationship between risk and evidence to be obtained when it states, “As the risk associated with the control being tested decreases, the evidence that the auditor needs to obtain also decreases.” (See paragraph 51.)

However, this guidance does not provide examples or further amplification to demonstrate the application of this concept, specifically, how risk impacts the nature or extent of evidence to be obtained. We believe that to fully explain this concept, the standard should add guidance, such as, “for example, in areas of low risk, where relevant company-level controls are strong and operating effectively, the nature of tests of controls may consist of inquiry and observation and/or a walkthrough, or a lower sample size, whereas in areas of higher risk, the nature and extent of tests would generally be more extensive.” A similar explanation to illustrate the *quality* of evidence to be obtained in areas of differing risk, such as work done by others versus the auditor’s own work, should be added to fully illustrate this point.

With respect to the extent of testing, we believe expanded discussion regarding the consideration of risk in use of sampling to test the effectiveness of controls would be beneficial. For example, further clarification would be useful where the auditor does not plan to place reliance on controls for financial statement audit purposes and how this impacts the definition of the population to be tested and related sample sizes. This could occur when the auditor is retained late in the year, or where there have been significant and pervasive changes in internal controls late in the year. Clarification about how these situations and the auditor’s risk assessment in general affect the extent of testing required to determine whether controls are effective at year-end will assist auditors in testing more efficiently.

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

   We believe that in areas of low risk, where company-level controls are operating effectively, testing in the prior year resulted in no exceptions, and the control has not changed from the prior year, walkthroughs would be sufficient to test the design and operating effectiveness of some of the more routine controls. However, we would expect that the same controls would generally not be evaluated in this manner for multiple consecutive years.

   Further, we are concerned with the provision that permits using the work of others to perform walkthroughs. We believe that walkthroughs are an important audit procedure in planning an integrated audit and assessing the risk of material misstatement. They assist auditors in the identification of control deficiencies, either from missing controls or design deficiencies, as well as evaluating the competence of the persons performing the controls and gathering information about what could go wrong. While we understand that the proposed standard envisions that work performed by others in this area would be under the direct supervision of the auditor, we believe that additional guidance should be provided to ensure that auditors do not over-rely on others to perform this important task, particularly in areas other than those with low risk.

- 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?**

   While we believe that the proposed definition of a significant deficiency is improved and more realistic than the former definition, we believe that additional guidance is necessary to help auditors appropriately apply judgment and to avoid inconsistencies in practice.

   To facilitate consistency in the evaluation of identified control deficiencies, as stated earlier, we recommend that examples of each type of deficiency, such as those included in Appendix D to AS 2, be retained (and modified as necessary to fit the revised definitions of a significant deficiency and material weakness contained in the proposed standard). Additionally, specific examples that are applicable to smaller companies would be useful, specifically examples related to segregation of duties issues and the risk of management override.

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?**

The evaluation of the severity of deficiencies in ICFR is a subjective process taking into account the following factors –

- whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement of an account balance or disclosure; and

- the magnitude of the potential misstatement resulting from the deficiency or deficiencies.

These subjective factors require auditors (and company management) to exercise professional judgment based on their knowledge and experience. In situations where auditors do not have a sufficient history with a company, this judgment becomes more complex. It can be extremely difficult to conclude that a material error could occur when one has not occurred, particularly in judgmental areas. Conclusions in this area require evaluations about a person's technical competence and consistency in maintaining that level of competence. Absent an error, it is often extremely difficult to conclude that a material error could occur.

To assist auditors in making these determinations, examples that illustrate certain fact patterns, that in one circumstance would result in a material weakness but in another would not, would be beneficial. Areas where additional guidance in the evaluation of deficiencies would be most helpful include deficiencies in the control environment (especially assessing the risk of management override, fraud risk, and audit committee effectiveness), deficiencies in client expertise in financial accounting and reporting, (particularly with respect to complex and infrequent matters), and deficiencies in segregation of duties.

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?

We do not believe that the proposed changes in the definitions will have a significant impact on the amount of effort auditors expend in identifying and analyzing deficiencies that do not present a reasonable possibility of material misstatement to the financial statements, although these changes may help in communication between auditors and management. However, we do believe that the elimination of examples in applying the definitions could significantly increase the amount of effort to analyze deficiencies.

- 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?

We believe that the standard should allow the auditor to conclude that no deficiency exists when one or more of the strong indicators are present. This flexibility in approach permits the auditor to exercise appropriate judgment based on the facts and circumstances of each situation without forcing a conclusion that a deficiency exists when one may not.

The use of judgment is preferable to a fixed conclusion that cannot contemplate the entirety of differing circumstances that may require consideration. However, we recognize that the application of judgment may cause inconsistencies in the evaluation of deficiencies. To address this concern, we suggest that examples be provided to illustrate circumstances that could result in the conclusion that no deficiency exists when one of the strong indicators provided in the proposed standard is present.

- Clarifying the Role of Materiality and Interim Materiality in the Audit

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

We do not believe further clarification is necessary to avoid unnecessary testing; however, we do believe further clarification to the scope should be considered to reduce the risk of insufficient testing. In particular, we are concerned that material areas may be inappropriately excluded from the scope of the audit.

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 in the definitions of significant deficiency and material weakness should be retained, since external financial reporting encompasses both quarterly and annual reporting. We believe identified deficiencies should be evaluated against both interim and annual financial results.

However, we are concerned that there will still be confusion about what this definition means as it relates to scoping an engagement (selecting areas for audit or designing procedures). The reason for this is as follows: Paragraph 2 of the proposed standard would require the auditor to perform the audit to obtain reasonable assurance about whether material weaknesses exist. A material weakness is defined in the context of either the annual or interim financial statements. Therefore, auditors may deduce from this that they need to design their tests to look for weaknesses that could generate misstatements that would be material to interim financial statements. This would be tantamount to using an interim materiality for planning purposes.

In addition, in circumstances where a material weakness has been identified, because the definition of a material weakness is included in the report, this could suggest to users of the report that the auditor has planned and performed the audit to identify weaknesses that are material to interim periods. We are concerned that the audit report would therefore be misleading to investors, since the audit has not been planned or performed to identify material weaknesses based on interim materiality.

To avoid this confusion, we recommend the proposed standard clarify that the auditor is required to test only those controls which if not operating effectively could result in a material misstatement to the annual financial statements.

Eliminating Unnecessary Procedures

- Removing the Requirement to Evaluate Management's Process

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

With the removal of the requirement to report on management's assessment, we believe there should no longer be any confusion as to the extent to which the auditor needs to evaluate management's work. While auditors still need to evaluate management's work in areas on which the auditor intends to rely, any "unnecessary" work in this area should now be eliminated.

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

We believe that an audit of ICFR can be effective without performing an evaluation of the quality of management's process. However, in order to use the work of others, auditors would still need to perform this evaluation in those areas where there is an intention to rely on management's work. In addition, management's assessment process often overlaps with and is part of management's monitoring controls, and some evaluation of the assessment process could be necessary in order to test the effectiveness of those controls. We believe it would be useful to provide additional clarification with respect to each of these points in the final standard.

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 that one opinion, only on the effectiveness of internal control, clearly provides investors with the necessary information about the scope of the audit and the opinion on the effectiveness of ICFR.

- Permitting Consideration of Knowledge Obtained During Previous Audits

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

We support permitting the auditor to consider knowledge gained in prior years related to individual controls in determining risk, and therefore impacting the nature, timing, and extent of testing in the current year. The approach outlined in the proposed standard directs the auditor to consider three risk factors (the nature, timing, and extent of procedures performed in prior years' audits; the results of that testing; and any changes in the control or its related process since the last audit) when determining the risk related to a given control in subsequent years' audits. We believe this is appropriate and consistent with concepts addressed in the May 16, 2005 guidance.

We suggest, however, including additional language that provides direction to auditors when information obtained in prior years may be irrelevant as a result of changes at the entity or the environment in which it operates.

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?

We believe that in the following circumstances a walkthrough may provide sufficient evidence of operating effectiveness.

- The control is an automated control or was tested for operating effectiveness in a prior year (as part of a financial statement or an ICFR audit, either by the current or predecessor auditor) and found to be effective;
- There is an assessed low inherent risk, including consideration of the complexity of the control and the degree of judgment or subjectivity involved in performing the control;
- There have been no significant changes in the volume or nature of transactions for which the control operates;
- There is no history of errors in the relevant assertion to which the control relates;
- It has been established that relevant company-level controls are operating effectively; and
- There is no identified risk of fraud related to the control

Further, we would not envision that the same controls would be evaluated via walkthrough every year; so that at least some low risk controls are tested more extensively for operating effectiveness each year.

-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 proposed standard's focus on the risk of material misstatement to the financial statements, in determining the scope of testing in a multi-location engagement, appropriately focuses audit attention on those locations or business units with the greatest degree of risk, and we believe this focus will contribute to efficiencies in the performance of these audits. While auditors will still need to obtain enough evidence to support the opinion, the elimination of the "large portion" requirement appropriately permits the auditor flexibility in scoping an engagement based on risk and materiality, in the same manner used for the audits of financial statements.

- Removing Barriers to Using the Work of Others

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?

The concept of an integrated audit contemplates the performance of one risk assessment process, one scoping analysis, and one assessment of the effectiveness of ICFR. To facilitate this integrated approach in an efficient manner, we believe that a single framework for using the work of others is appropriate. We are concerned however, that the introduction of specific provisions in the proposed auditing standard, *Considering and Using the Work of Others in an Audit,* that permit reliance on the work of others, other than internal audit, could compromise audit integrity in some cases. When assessing the competence of internal auditors, under AU sec. 322, external auditors consider the professional experience, educational level, and quality of work of the internal auditors, among other factors. While these factors are similar to those presented in the proposed standard, the factors included in AU sec. 322 are considered in the context of competence in internal auditing matters and not in any other context. The proposed standard is not specific about the nature of the competencies. This may lead auditors to believe that if a corporate employee is competent in performing the daily tasks, this person could perform substantive audit procedures, when in fact the employee may have no experience in auditing.

Additionally, the auditor ordinarily considers the following matters in an assessment of the internal audit function: organizational status within the entity, application of professional standards, audit plan, access to records, and whether there have been any limitations on the scope of their activities. Further, internal audit departments are often in a unique position organizationally (often reporting directly to the Board of Directors or the audit committee), and generally comply with professional standards developed for the professional practice of internal auditing by The Institute of Internal Auditors and the General Accounting Office, all of which contribute to the competence and objectivity of internal auditors.

The proposed standard on using the work of others does not contain these necessary considerations for using the work of others. As such, we are concerned that audit effectiveness may be reduced through the inappropriate use of the work of others in performing substantive tests in relation to a financial statement audit.

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?

We believe that the proposed standard captures the correct scope of activities that should be considered as relevant activities; however, we suggest providing additional guidance about (1) how and when the auditor would be expected to obtain this understanding as part of the integrated audit, and (2) the expected form of documentation that would be necessary to evidence completion of this presumptively mandatory requirement to search for relevant activities.

With respect to documentation, we are concerned with the possible unintended consequences relative to the interaction between the documentation requirements in the proposed standard and the Board's Auditing Standard No. 3, *Audit Documentation*, as a result of the extensive use of the words "should" and "must" in the proposed standard. The use of these terms, for other than a performance requirement, has the potential to drive a level of documentation that would not add to the effectiveness of the audit. Therefore, we recommend that the Board reconsider the use of the words "should" and "must" to ensure that disproportionate auditor effort is not unnecessarily devoted to 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?

Obtaining this understanding is important to the auditor's assessment of risk, and as such we believe that this requirement will improve audit quality.

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

We believe that the concept of principal evidence, that is, that the auditor's own work should provide the principal evidence for the auditor's opinion, does not change whether or not the principal evidence concept is reflected in the standard. The audit opinion is the responsibility of the auditor alone and, since this responsibility is not a shared one; the judgment about the sufficiency of evidence to support the opinion can only be made by the auditor. Therefore, while we agree that there is no need to define "principal evidence," we believe that the standard should clearly state that the auditor is solely responsible for the audit, so the auditor should perform sufficient work to support the opinion.

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?

With the increased emphasis on using the work of others, it is important that the framework for evaluating the competence and objectivity of persons performing testing be clear and unambiguous. We believe that the proposed standard is unclear in a number of respects:

- With respect to competence, the standard should clearly state that when the auditor is assessing competence, this assessment relates to competence with respect to auditing principles and internal control testing procedures. Competence in areas other than these is irrelevant. This clarification was not necessary in AU sec. 322, since that standard dealt with the auditor's consideration of the internal audit function only. Please see our response to question 19 for further discussion.
- With respect to the smaller company environment, additional guidance would be useful about how reliance on the work of others may be accomplished. The smaller company environment is unique in that areas of concern such as segregation of duties and the risk of management override may hinder efforts to use the work of others.
- We also believe that the discussion of risk and its impact on the extent of the use of the work of others, included in paragraph 11 of the proposed standard, should be expanded to include concepts similar to those in paragraphs 21 and 22 of AU sec. 322:

    Paragraph 21 provides that when the risk of material misstatement or the degree of subjectivity involved in the evaluation of the audit evidence is high, the auditor should perform sufficient procedures to fulfill his or her responsibility to obtain sufficient, competent evidential matter to support the auditor's report. Consideration of the use of internal auditors' work in these circumstances cannot alone reduce audit risk to an acceptable level to eliminate the necessity for the auditor to perform tests of those assertions directly.

Paragraph 22 provides that for assertions related to less material amounts, where the risk of material misstatement or the degree of subjectivity involved in the evaluation of the audit evidence is low, and after consideration of certain other factors, such that audit risk has been reduced to an acceptable level, direct testing of the assertions by the auditor may not be necessary.

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

Please see our response to question 19 above.

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?

We believe it is appropriate to consider the company's policies addressing compensation arrangements for individuals performing tests of controls as a factor in concluding on objectivity. However, we do not believe that any person on the company's payroll is automatically rendered not objective.

- 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?

We believe that this approach may reduce the number of walkthroughs performed in certain circumstances where a company has a lot of less significant or low risk sub-processes. We do not believe audit quality is impaired by this change as the proposed standard appropriately considers that differing transactions within a significant process may have different associated inherent risks and may affect the types of controls necessary to adequately address the risks. The proposed standard also discusses the concept of probing inquiries to ensure the auditor gains a sufficient understanding of the process and is able to identify important points at which a necessary control is missing or not designed effectively.

We also believe that the use of probing inquiries may be appropriate instead of a walkthrough for some other processes in addition to the period-end financial reporting process described in the standard. For example, in a process where there are only a few transactions (which are material) that flow through the process, we believe that probing inquiries may in some instances be more efficient than a walkthrough. We recommend that rather than giving one example, such as the period-end financial reporting process, that the proposed standard provide factors auditors should consider when evaluating whether walkthroughs or the use of probing inquiries provide sufficient evidence about how transactions are recorded.

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?

Using the work of others as direct assistance in the performance of walkthroughs *may* be appropriate in areas that the auditor considers to be low risk. However, we would expect to use others in this role on a rotational basis to introduce unpredictability into the audit approach.

- 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?

An audit of ICFR for smaller public companies presents unique challenges that require auditors to consider each company's unique facts and circumstances in developing an audit approach. Smaller public companies, by their nature, are less complex and have control structures that are often less formal than their larger counterparts. We believe that the proposed standard appropriately recognizes these differences as it requires auditors to consider a company's size and complexity when planning audit procedures.

While we agree that this evaluation is appropriate, we believe that the consideration of the size and complexity of a company may at times be apparent, based solely on its mere size, so that there should be no need for documentation regarding this evaluation in such circumstances. As such, we believe that the requirement that states, "The auditor should document how the size and complexity of the company affected the audit," may drive a documentation requirement that may not be appropriate in all instances and therefore result in inefficiencies.

In this regard, it is unclear what documentation would be required to evidence consideration of these factors. It is not clear whether it would be necessary to document this consideration for each engagement within the engagement workpapers, or whether this could be accomplished solely through a firm's audit methodology and training that would emphasize these items.

Further, we believe that there are sometimes differences in how an ICFR audit is integrated with a financial statement audit for smaller public companies that should be addressed in the proposed standard. For example, it might make sense in some situations, such as where the client lacks appropriate segregation of duties and/or lacks appropriate accounting knowledge and expertise such that reliance on controls in the financial statement audit is not contemplated, that efficiencies may be gained by concentrating ICFR testing at year end rather than throughout the year. This would allow for smaller sample sizes based on the smaller population being tested.

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

We have no comments on this question.

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?

We believe that it would be useful to include additional guidance with respect to testing controls that are based on management's daily interaction, including how to determine these controls are effective when there is minimal written documentation evidencing the operation of the control.

When only less formal documentation is available, the proposed standard allows inquiry and observation to support operating effectiveness. We suggest that this lower level of evidence be permitted only in circumstances where this approach is supported by the risk assessment. This approach recognizes that the lower the auditor's assessment of risk of material misstatement, the more likely that inquiry and observation would be appropriate tests of the operating effectiveness of controls.

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

We have no comments on this question.

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?**

    While we agree that market capitalization and revenue thresholds are useful indicators of a company's size for setting regulatory reporting requirements, we do not believe that these thresholds are necessarily the only relevant factors for purposes of planning and performing an audit of ICFR.

    There is no bright line that distinguishes a smaller company from a larger one. Therefore, we believe that the determination about the size and complexity of a company should be left to auditor judgment based on criteria set forth in the proposed standard and as set forth in the Internal Control over Financial Reporting – Guidance for Smaller Public Companies, published by the Committee of Sponsoring Organizations.

<u>Proposed Rule 3525 – Audit Committee Pre-approval of Services Related to Internal Control</u>

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?**

    We believe that the scope of services to be provided should be discussed with and approved by the Audit Committee. The proposed standard states that in circumstances where the auditor concludes it will be necessary to disclaim an opinion, no additional work should be performed after such determination is made. We believe that the standard should require the auditor to discuss this situation with the Audit Committee and require the Audit Committee to determine whether or not any additional testing of controls should be performed.

<u>Effective Date</u>

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?**

    We believe that the sooner the new standard is adopted, the more audit firms will be able to take advantage its benefits. We believe that auditors should be permitted to use the provisions of the final standard to support any opinion dated after the release of the standard, but the standard should not be mandated for audits of companies that have a year-end within 6 months of the date the standard is released.

Additional Comments for the Board's Consideration

- Relevant Assertions

Paragraph 31 of the proposed standard on auditing internal control directs auditors to identify relevant assertions by determining the "likely sources of those potential misstatements in each significant account that would cause the financial statements to be materially misstated." This contrasts with AICPA Statement on Auditing Standards ("SAS") No. 106, which defines a relevant assertion as having a "meaningful bearing" on whether an account is fairly stated. Using the AICPA definition, all assertions, other than those that are truly not applicable would be considered to have a "meaningful bearing," even though they may be lower risk.

There seems to be a difference in focus between these two definitions such that a relevant assertion under SAS 106 would not necessarily be a relevant assertion under the proposed standard. For example, if the fixed asset financial statement account is considered a significant account, under SAS 106, the relevant assertions would ordinarily include: existence or occurrence, completeness, valuation or allocation, rights and obligations, and presentation and disclosure. However, these same assertions may not necessarily be considered relevant assertions under the proposed standard, since relevant assertions are based on the likely source of potential misstatement.

We understand that the Board has not adopted SAS 106. However, we are concerned about the confusion that may arise from different meanings for the same term. If this difference in focus is the intention of the Board, we believe this distinction should be made more clearly, and examples that demonstrate how this consideration should be made would be helpful.

- Foreign Private Issuers

The Securities and Exchange Commission has provided guidance to management about how to plan and conduct its evaluation process for foreign private issuers (based on their primary financial statements) in addition to how to evaluate control deficiencies (in relation to both the amounts reported in the primary financial statements and amounts reported in the U.S. GAAP reconciliation). We suggest that the Board provide equivalent auditing guidance to reduce the likelihood of auditors and management reaching different decisions about scoping and the severity of deficiencies in these circumstances.

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We appreciate your consideration of our comments and suggestions and we would be pleased to discuss these with you at your convenience. Please direct any questions to Wayne Kolins, National Director of Assurance at 212-885-8595 (wkolins@bdo.com)

Very truly yours,

/s/ BDO Seidman, LLP

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