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Office of the Secretary
PCAOB
1666 K Street NW
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 021

Microsoft appreciates the opportunity to comment on the Public Company Accounting Oversight Board (“PCAOB”) proposed auditing standards, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and *Considering and Using the Work of Others in an Audit* (“proposed standards”).

Microsoft recognizes and appreciates the time and effort that the PCAOB has dedicated to developing standards that are responsive to concerns that have been raised, particularly about the effectiveness and efficiency of the process of auditing internal controls over financial reporting (ICFR). We support the direction of the proposed standards in improving the balance between quality and efficiency of the audits by supporting a top-down, risk-based approach, encouraging broader auditor flexibility and judgment, and supporting the use of prior knowledge and assessment results. We have strong concerns about maintaining consistency between the external audit and management assessment approaches and about the support the auditors will receive from the PCAOB in implementing the proposed standards. We also have comments on a few other topics.

Improvement in quality and efficiency

We believe that the proposed standards set the stage for meaningful improvements in effectiveness and efficiency of audits of ICFR. The top-down, risk-based approach that is the foundation of the proposed standards should enable auditors to focus attention on the critical controls that would detect a material misstatement, which should also result in a reduction in the key controls tested.

The proposed standards allow for broader auditor flexibility and judgment. The requirements to perform walkthroughs are being focused on significant processes. The auditor is given greater freedom in choosing how to test controls, with an acknowledgement that documentary evidence may not exist for all controls, which could then be tested with a combination of inquiry and observation.

The proposed standards also encourage the use of prior knowledge and audit results to guide the risk assessment and testing approach, reducing the required evidence in subsequent years based upon the type and results of prior years’ testing and the stability of the controls. Also, the proposed standards explicitly provide for benchmarking of automated controls.

The second proposed standard expands the potential for auditor reliance on the work of others, which should better align the audit and the management assessment and leverage management's more in-depth knowledge of the controls. It removes the "principal evidence" requirement and also removes the requirement for original work in testing of controls in the control environment. We support these changes and believe that they will result in increased efficiencies.

Consistency with management assessment approach

We expect to make meaningful changes in our management assessment of ICFR based upon the current exposure draft of the U.S. Securities and Exchange Commission's ("SEC") proposed interpretive guidance ("proposed guidance"). In light of these anticipated changes, we are concerned with maintaining good coordination and consistency between management's assessment and the external auditors' standards and practices, including PCAOB Audit Standards, PCAOB inspection practices, and external audit firms' policies, practices and proposed standards. To optimize reliance and achieve quality and efficiency objectives, management's assessment approach will need to be consistent with and acceptable to the external auditors' standards. Furthermore, even though the requirement for an opinion on management's assessment process has been recommended for elimination, a management assessment approach that varies too greatly from the auditor's viewpoint could be of concern.

With all of the positive changes in the proposed standards, we believe that good potential exists for meaningful improvements in audit effectiveness and efficiency and alignment with management assessment changes. As clients, companies have a vested interest in these improvements. We also have strong concerns about the auditors' ability to realize these efficiencies.

As a general statement, we believe that external auditors may not move as quickly as their clients might expect in implementing the changes noted above. It seems likely that auditors will be concerned about whether the PCAOB inspection practices will mirror the proposed standards.

To alleviate these concerns, auditors will need to be assured that the PCAOB inspections will be aligned with the proposed standards. Because of the time lag between audits and inspections, the PCAOB will need to clearly communicate that the inspections will be aligned with the proposed standards for audit years starting with the effective date. This communication can take a variety of forms, including workshops or educational forums. We also suggest that the PCAOB monitor the external audit firms' guidance for implementing the proposed standards and be involved in any efforts to develop additional interpretations or practice aids that elaborate on the concepts in the proposed standards.

Other comments

Consideration of interim financial statements

For purposes of deficiency evaluation, the proposed standard includes a misstatement of the company's "annual or interim financial statements" in the definition of "material weakness" and "significant deficiency." We believe that the reference to interim financial statements could result in companies' having to use an inappropriately low quantitative threshold to evaluate control deficiencies. In our view, deficiencies should be evaluated and classified based upon

their potential future impact on annual financial statements, since the management assessment addresses whether controls are operating effectively as of the end of the year. The impact of control deficiencies that are identified during the year should be extrapolated and compared to an annual quantitative threshold (in addition to considering qualitative factors, of course). Therefore, we believe that the words “or interim” should be removed from the definitions of a material weakness and a significant deficiency.

Company-level controls

The proposed standard refers to company-level controls in paragraphs 16 and 17 stating that these controls should be tested and considered in determining the scope of other testing. Also in paragraph 43 the proposed standard indicates that company-level controls could be relied upon to prevent or detect misstatements to one or more relevant assertions.

At Microsoft we have documented and tested company-level controls in lower risk areas to allow us to focus on the most important and pervasive controls, with the additional benefit of reducing or eliminating testing of process level controls. We expect to expand this practice next year in implementing the SEC proposed guidance. Controls that we have relied on in this manner include variance analyses, management reviews, and monitoring activities, which have a direct relationship to financial statement assertions. From our discussions with other companies, we believe that these are fairly common types of direct company-level controls. If needed, we are willing to provide examples of company level controls that we rely upon and/or participate in efforts to develop supplemental information about company-level controls.

IT general controls

The proposed standard touches very lightly on the subject of information technology and refers the auditor to AU sec. 319 for a discussion of IT risks to consider. General IT controls are a difficult area for many companies in that they are often over-scoped and over-tested. We believe that the proposed standard should emphasize that auditors can be quite selective in limiting IT controls in scope to only those that are necessary to adequately address material financial reporting risks. In our response to the SEC proposed guidance, we are suggesting examples of such controls. While the examples may not need to be as extensive in the proposed standards, some level of detail could be included to elaborate on the point that the audits of IT controls can be more limited than they are today. The suggestions for examples that we provided to the SEC are as follows:

1. Access to programs and data - Limiting user access testing to the few, high risk accesses that create potential for material misstatements. These accesses should be directly tied to identified financial statement risks. Any guidance that could be developed about types or expected numbers of accesses that might be relevant for a typical large-sized, complex company would be helpful.
2. Program development and changes – Examples of adequate controls to prevent material misstatements. We expect these examples might include a small number of key controls, such as final user acceptance testing and move-to-production final sign-offs.
3. Operations – Examples of typical critical key controls, such as backup of key financial data tied to material risks.

Deficiency evaluation

For many companies, deficiency evaluations have been structured using a framework that was developed by several of the larger audit firms. This framework has been useful in driving consistency of thought and communication but has also been restrictive. The factors laid out in the proposed standard to consider in evaluating control deficiencies or combinations of deficiencies are helpful and provide more room for judgment. We suggest that the proposed standard include a statement that the deficiency evaluation factors in the standard can be used instead of the more prescriptive framework.

In addition to the comments above, we have included responses to several of the specific questions posed in the proposed standards in the Appendix to this letter.

In conclusion, we want to reiterate our appreciation for the thoughtful consideration of input and the development of proposed standards that we believe will allow for meaningful improvements in audits of ICFR. If you have any questions or would like to discuss any of our comments, please contact Marilee Byers at (425) 706-2122 or marileeb@microsoft.com.

Sincerely,



Frank H. Brod
CVP Finance and Administration



Robert W. Weede
Assistant Corporate Controller



Marilee Byers
Director, Financial Compliance Group

APPENDIX

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

We believe that the proposed standard does clearly describe a top-down approach. The top-down, risk-based approach that is the foundation of the proposed standards should enable auditors to focus attention on the critical controls that would detect a material misstatement, which in many cases could also result in a reduction in the key controls tested. The change in the wording of the likelihood component of the material weakness definition from “more than remote” to “reasonable possibility” and the change in the magnitude component of the significant deficiency definition from “more than inconsequential” to “significant” should allow for increased judgment and better focus in determining significant deficiencies.

In the structure of the proposed standard, risk assessments focus audit effort on the most important areas. Identification of significant accounts to include in scope, selection of relevant assertions, controls and the nature and extent of testing evidence to be obtained are all independently determined based on relevant risks. For companies with multiple locations, the proposed changes in the multi-location guidance shift the focus from an emphasis on coverage to an emphasis on identifying and including high-risk locations. At each decision point, the application of thoughtful risk assessments should focus the audit effort.

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

Fraud is discussed in paragraph 45 as a factor that should be considered along with relevant assertions. Including fraud as a consideration for each significant account, similar to how assertions are considered, gives it an appropriate level of importance.

We have a concern about paragraph 79, which indicates that fraud “of any magnitude” on the part of a senior management should be treated as a strong indicator of a material weakness. While senior management fraud must certainly be taken very seriously, we suggest that it would not necessarily rise to the level of a material weakness. This is particularly true given the broad definition of “senior management” that is included in paragraph 79.

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

Yes, in our opinion the top-down approach does accomplish that purpose. We believe that a positive result of the top-down approach will be to highlight and focus on substantial and pervasive controls, such as self-audits or other types of monitoring controls that provide better coverage and assurance than testing a small sample of a given population. We can envision that companies will strengthen or develop those types of monitoring controls in some areas where they do not exist today, which would improve the companies’ control structures. A side benefit is that there will likely be fewer key controls to test.

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

The proposed standard refers to company-level controls in paragraphs 16 and 17 stating that these controls should be tested and considered in determining the scope of other testing. In paragraph 43 the proposed standard indicates that company-level controls could be relied upon to prevent or detect misstatements to one or more relevant assertions.

At Microsoft we have documented and tested company-level controls in lower risk areas to allow us to focus on the most important and pervasive controls, with the additional benefit of reducing or eliminating testing of process level controls. We expect to expand this practice next year in implementing the SEC proposed guidance. Controls that we have relied on in this manner include variance analyses, management reviews, and monitoring activities, which have a direct relationship to financial statement assertions. From our discussions with other companies, we believe that these are fairly common types of direct company-level controls. If needed, we are willing to provide examples of company level controls that we rely upon and/or participate in efforts to develop supplemental information about company-level controls.

The SEC proposed guidance makes a distinction between entity-level controls that are directly or indirectly related to a financial reporting element. Directly related controls can be designed to adequately prevent or detect misstatements, whereas indirectly related controls typically would not adequately address a specific risk for a financial reporting element. This is a helpful distinction in discussing company-level controls, and we suggest that the proposed standard be revised to include this idea.

Finally, it would be helpful for the SEC and the PCAOB to use the same terminology in discussing these controls, adopting either “company-level” or “entity-level” as a common descriptor.

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?

In the structure of the proposed standard, risk assessments focus audit effort on the most important areas. Identification of significant accounts to include in scope, selection of relevant assertions and controls and the nature and extent of testing evidence to be obtained are all independently determined based on relevant risks. For companies with multiple locations, the proposed changes in the multi-location guidance shift the focus from an emphasis on coverage to an emphasis on identifying and including high-risk locations. At each decision point, the application of thoughtful risk assessments should focus the audit effort.

The proposed standard also contains a useful description of risk factors to use in determining significant account risk and control operating effectiveness risk. Because the proposed standard discusses these two risk assessments separately, it makes it clear that they are not interdependent. A key control over a high risk significant account or process could be assessed to be low risk in terms of its operating effectiveness, which would affect the type and extent of testing. We believe that this flexibility to apply judgment to the testing process will be beneficial.

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

For lower risk controls, we believe it is possible that the performance of a walkthrough could be sufficient. As mentioned in the response to question 5, these lower risk controls could include controls over high risk accounts or transactions, if the control environment was strong, the control had a history of operating effectiveness, the control design had not been changed, and prior years' test results were favorable. A walkthrough might also be sufficient for controls that do not lend themselves to examination of evidence, such as some of the indirect company-level controls.

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 definition is probably sufficient although somewhat vague. Because the significant deficiency definition is primarily relevant in determining which deficiencies should be reported to the Audit Committee, the interpretation of the definition will likely be in the context of what would be significant to the Audit Committee and members of senior management who exercise similar financial statement oversight. The proposed definition is more reasonable and allows for companies to focus on more important financial reporting matters than under the prior definition which included the phrase "more than inconsequential."

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?

We have no direct experience with this issue but are not aware that auditors are not appropriately identifying material weaknesses. The proposed standard states quite clearly, particularly in paragraph 72, that a deficiency should be evaluated by determining whether there is a reasonable possibility that the controls **will** fail to prevent or detect a misstatement, not whether they **did** fail to prevent or detect a misstatement.

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 believe that the proposed changes will probably reduce the amount of effort devoted to identifying and analyzing deficiencies. The current definitional terms "more than remote" and "more than inconsequential," although subject to judgment, seem to imply a broader spectrum of possible outcomes than "reasonable possibility" and "important enough to merit attention by those responsible for oversight of...financial reporting." We believe that fewer issues will appear to be on the margin between "deficiency" and "significant deficiency" under the new definition and therefore less effort will be devoted to the analysis.

For many companies, deficiency evaluations have been structured using a framework that was developed by several of the larger audit firms. This framework has been useful in driving consistency of thought and communication but has also been restrictive. The factors laid out in the proposed standard to consider in evaluating control deficiencies or combinations of deficiencies are helpful and provide more room for judgment. We suggest that the proposed

standard include a statement that the deficiency evaluation factors in the standard can be used instead of the more prescriptive framework.

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 proposed standard should allow an auditor to exercise judgment over whether a deficiency exists. In the presence of a strong indicator of a material weakness, the auditor is not likely to conclude that there is not a deficiency, but it is possible, especially if the magnitude of the indicator were quite small. The auditor would need to defend his/her judgment and document it appropriately, particularly for one or more of the strong indicators stated in the proposed standard.

Any time judgment is involved, there is the potential for inconsistency and this is certainly true in the evaluation of deficiencies. Whether there will be more inconsistency with this change is difficult to predict.

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

We believe that additional guidance regarding IT general controls would be very helpful. Specific suggestions are included in the body of the letter.

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?

We believe that the reference to interim financial statements could result in companies' having to use an inappropriately low quantitative threshold to evaluate control deficiencies. In our view, deficiencies should be evaluated and classified based upon their potential future impact on annual financial statements, since the management assessment addresses whether controls are operating effectively as of the end of the year. The impact of control deficiencies that are identified during the year should be extrapolated and compared to an annual quantitative threshold (in addition to considering qualitative factors, of course). Therefore, we believe that the words "or interim" should be removed from the definitions of a material weakness and a significant deficiency.

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

Removing the requirement for an evaluation of management's process will not have a significant impact on the audit work, in our opinion. Based on discussions with our auditors and observations of their process, it seems clear that they are not spending a significant amount of time specifically auditing management's process.

The other reason that removing the requirement will not have a large impact is that we will want to continue to align our management assessment process with the external audit process to

optimize auditor reliance on the work of others. The auditors' reliance on our work will undoubtedly continue to require some retesting of management's assessments.

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

The auditor can perform an effective audit without performing a direct evaluation of the quality of management's process. To the extent that management's assessment process is intertwined with the operation of the controls (e.g., monitoring processes) or the auditor is relying upon management testing, then the auditors will have to continue to perform some type of indirect assessment of management's process.

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?

The introductory paragraph of the sample opinion in paragraph 96 of the proposed standard still states that the auditor has "audited management's assessment...that W Company maintained effective internal control over financial reporting..." The Opinion paragraph clearly concludes on the effectiveness of ICFR, but the inconsistency is potentially confusing. The important judgment and opinion is that the controls are operating effectively and that is described in the Scope and Opinion paragraphs.

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

The proposed standard does provide for using cumulative knowledge in determining the extent of testing, as described in paragraphs 65 through 69. However, except for specifically mentioning benchmarking of automated controls, the proposed standard does not allow for rotation or benchmarking of control tests. We believe that rotational testing can be appropriate in areas other than automated controls and would like to see the standards allow for that possibility based on the judgment of the auditors.

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?

For lower risk controls, we believe it is possible that the performance of a walkthrough could be sufficient. As mentioned in the response to question 5, these lower risk controls could include controls over high risk accounts or transactions, if the control environment was strong, the control had a history of operating effectiveness, the control design had not been changed, and prior years' test results were favorable. A walkthrough might also be sufficient for controls that do not lend themselves to examination of evidence, such as some of the indirect company-level controls.

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 believe that the approach for determining multi-location testing scope will result in more efficient audits. With the current requirement to include a large portion of the company in scope, the auditor may not have been able to fully consider qualitative risks. The risk-based

approach will probably remove from testing locations that have been included simply to reach a quantitative limit or could bring locations into scope that have been excluded purely on quantitative grounds. Also auditors may have more flexibility to consider centralized, company-level and/or monitoring controls that may provide equivalent or greater coverage. Whatever the specific outcome, the focus on risk and judgment is an improvement over the current requirements.

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 same principles should apply for relying on the work of others, whether for an integrated audit or a financial statement audit. The requirements for competence and objectivity should be equally important in either scenario. The particular required competencies of the people performing the work may vary, but the framework should be the same.

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 as “tests performed by others that provide evidence about the design and operational effectiveness” seems to be too restrictive. Monitoring activities would not typically be thought of as “tests performed” but are likely to be quite reliable in certain circumstances. The definition should be modified to be more inclusive, using terms such as “activities” or “monitoring processes” or “assessments”, instead of, or in addition to, the more restrictive “tests.”

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

Yes, we believe that the auditor should have a full understanding of any control deficiencies, fraud or misstatements identified by others performing relevant activities.

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

In our opinion it is not necessary. If the auditor has decided that he/she can rely on the work of others based on the competence and objectivity standards, then the other parties should be able to provide sufficient evidence.

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?

We believe that the criteria may be too restrictive and onerous. We favor giving the auditors more judgment in how they determine competence and objectivity. This could be accomplished

by changing the first sentence of paragraph 14 to read, “Factors relevant to the assessment of the competence of the individuals performing tests **could** include, **for example –**”.

We are interested in the auditor having the flexibility to rely on management testers in addition to Internal Audit. In many companies the Sarbanes-Oxley program management individuals are equally competent and also objective in terms of field locations, although they may not report organizationally to the Audit Committee. The “organizational status” section in paragraph 15.b. could be interpreted to limit reliance to Internal Audit. A suggested change is to remove the first two bullet points of paragraph 15.b. Alternatively, the language could be changed to add that the responsible persons could report to a person of sufficient status and objectivity to serve an oversight function similar to an Audit Committee function.

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

Other factors that could be considered for assessing competence are the person’s knowledge of the processes, controls and accounting in the areas where the person is performing relevant activities, and also participation in the company’s program for training on Sarbanes-Oxley compliance requirements in general and specific to the company.

As mentioned above, the “organizational status” section seems to lean heavily in favor of the use of Internal Audit personnel, even though we believe one of the intents of the proposed standards was to expand the population of others who can be relied upon. See response to question 23 for suggested changes.

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?

As a practical matter, individuals performing the testing are probably not often in a position to influence their own compensation by how they perform the testing or report the results. Adding compensation policies as a factor of objectivity does not seem necessary.

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

Requiring a walkthrough only for significant processes should reduce the number of walkthroughs which are currently performed for all transactions. We support this change that allows for auditor judgment to determine when walkthroughs are necessary to maintain audit quality.

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?

We believe that the proposed standard should allow the auditor to more broadly use the work of others in performing walkthroughs, including complete reliance on the work of others if the auditor determines that the quality or rigor of the walkthrough would not be compromised. If performed by competent and objective testers and if properly documented in a manner that can be appropriately reviewed and evaluated by the auditors to meet their reliance standards, walkthroughs should be no different than other testing in terms of reliance.

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?

We believe that the principles of the proposed standard apply very appropriately to large and small companies. The top-down, risk-based approach provides a good degree of flexibility that can be applied to tailor the audit approach to fit the company's circumstances, large or small. The additional language included in the proposed standard to address differences between small and large companies is helpful and is appropriate to all companies. We do not believe that additional language or guidance is needed.

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?

In our opinion, the effective date should be as early as possible in calendar year 2007. An early effective date will make it possible for auditors and management of calendar year companies to work together to incorporate proposed standard changes in scope and plans for 2007 audits and assessments.