June 21, 2007

Rule Comments
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: File No. PCAOB-2007-02; Release No. 34-55912
Public Company Accounting Oversight Board ("PCAOB" or "the Board"); Notice of Additional Solicitation of Comments on the Filing of Proposed Rule on Auditing Standard No. 5, *An Audit of Internal Control over Financial Reporting That Is Integrated with an Audit of Financial Statements* ("AS5"), and Related Independence Rule Conforming Amendments
June 15, 2007

Dear Commissioners,

I submit my comments to you regarding the above referenced File Number. These are my personal comments and do not necessarily reflect those of my employer. You asked for additional comments regarding the above referenced PCAOB auditing standard including seven (7) questions or issues to be addressed.

**1. Is the standard of materiality appropriately defined throughout AS5 to provide sufficient guidance to auditors? For example, is materiality appropriately incorporated in the guidance regarding the matters to be considered in planning an audit and the identification of significant accounts?**

The fifth bullet point in Paragraph 9 is where I first see the term "materiality" used. This is the first paragraph under the sub-heading *Planning the Audit*. However, materiality is not further defined for audits of internal control over financial reporting ("ICFR") until Paragraph 20, in which the PCAOB writes, "In planning the audit of internal control over financial reporting, the auditor should use the same materiality considerations he or she would use in planning the audit of the company's annual financial statements." The auditor is asked to use the same "considerations," but is not specifically advised to use the same *amount* for materiality. One may infer that the same considerations will ultimately yield the same number.

Throughout AS5 the Board uses terms that include some variation of the word "material," including "material weakness." Since the overarching goal is to identify a material weakness in ICFR leading to a material misstatement on the financial statements, linking materiality amounts in both audits ought to be stated. One may also argue that Paragraph 20 could be moved up ahead of what is presently Paragraph 9, or incorporated into Paragraph 9.

I do not like Paragraph 30 because materiality is not mentioned. Here the PCAOB opens the door for a "bottom-up" approach. An auditor can come up with many answers to the Board's

suggested question, "...'what could go wrong' within a given significant account or disclosure?" This concept made Auditing Standard No. 2 ("AS2") a behemoth (see Paragraph 26 of AS2). If the auditor believes a certain account has a high risk of material misstatement during the planning phase of the audits of financial statements and internal control over financial reporting, the auditor ought to test the numbers and the controls surrounding those numbers (and related disclosures) before asking a "What if" question.

Upon completion of the audit test procedures mentioned above, the question the auditor needs to then ask is, "Given these results, am I still concerned that there remains a high risk of a material misstatement within this account?" If there are no deficiencies in the controls – or any deficiencies found are within the bounds of statistical insignificance (and human error expectations) – then there may be no reason for asking, "What could go wrong?" If the audit results are borderline, or conflicting (such as the numbers and disclosures appear accurate, but the controls were designed poorly, or weak), then asking "What if" is warranted.

2. **Please comment on the requirement in Paragraph 80 that the auditor consider whether there are deficiencies or combinations of deficiencies that are significant deficiencies and, if so, communicate those to the audit committee. Specifically, will the communication requirement significant deficiencies divert auditors' attention away from material weakness?**

The Commissioners may be asking the wrong question regarding "significant deficiencies." Having a middle ground has its benefits. However, I am concerned that too many auditors will want to raise a "significant deficiency" up to a "material weakness," especially if there are two or more deficiencies. For instance, if there is a problem with an audit, the auditors' judgment will be at issue. Specifically, why did the auditors judge a deficiency to be a significant deficiency and not a material weakness (albeit in hindsight)? I do not believe this required communication will divert auditors away from material weaknesses, but will rather encourage more deficiencies to be reported as material weaknesses when management deems them significant deficiencies.

My suggestion would be to do away with the middle category. A control is either effective in design and operation or it is not. Neither the Board nor the SEC has defined how far below material a significant deficiency is "just a deficiency." For example, a control fails and the auditor determines that the potential misstatement is $100,000. If materiality for both audits is deemed to be $1,000,000, is ten percent of that figure significant? Should the threshold be set at fifty percent? Since auditors already derive a figure for "individually significant items" for financial statement audits, this same figure could carry over along with materiality to the ICFR audit. If there is no middle (see also "gray") area, then the auditors ought to be encouraged to communicate *all* deficiencies to the Audit Committee (which appears to be the preference per Paragraph 81). With materiality clearly defined for both parties, disagreements between management and auditors could be reduced. This will allow management and auditors to focus on what is material to the financial statements taken as a whole, which leads to the Commissioner's third question.

3. **Is AS5 sufficiently clear that for purposes of evaluating identified deficiencies, multiple control deficiencies should only be looked at in combination if they are related to one another?**

   The second note at the end of Paragraph 65 does seem to state this. The deeper question is whether this is correct. Suppose an auditor discovers five deficiencies in three accounts that aggregate to $1,000,000 – deemed to be material. That ought to be reported as a material misstatement especially because more than one account is affected. In fact, the auditor may have already decided to increase the level of testing on both audits because of the breadth of the deficiencies and misstatements. Ultimately, the auditor is asked to express an opinion on the financial statements taken as a whole. The opinion on ICFR ought to be similar, that is, taken as a whole of the ICFR within the company. See the note in Paragraph 46 and Paragraph B1.

4. **Please comment on whether the definition of "material weakness" in Paragraph A7 (which is consistent with the definition that the SEC adopted) appropriately describes the deficiencies that should prevent the auditor from finding that ICFR is effective.**

   This is not a great definition because it does not – and I should suggest cannot – quantify "reasonable possibility." The term has been used for a long time in the accounting and auditing profession, so both external auditors and management are familiar with the concept. Therefore, short of attempting to quantify the definition, it ought to stay as presented.

5. **Is AS5 sufficiently clear about the extent to which auditors can use the work of others?**

   Paragraph 19 could be made more robust by adding some language similar to what follows. "Building from prior years' experience with the issuer (discussed in Paragraphs 57 through 61), the auditor may rely completely upon others' work for low risk controls. Furthermore, the auditor ought to rely upon management's benchmarking automated controls that have not changed to further reduce testing requirements."

   We find in Paragraph 18 that auditors need to "assess the competence and objectivity of the persons whose work the auditor plans to use..." The Commission's interpretive guidance as released for comment in December 2006 states on page 36 that, "...management can vary the nature of evidence from on-going monitoring by adjusting the extent of validation through periodic direct testing of the underlying controls and/or adjusting the objectivity of those performing the self-assessments." [See File No. S7-24-06] If this remains in the final guidance the Commission approved, it may have a negative impact on AS5's goal to promote the use of more of management's work. The auditor is asked to evaluate the competence and objectivity (Paragraph 16) and instructed that there must be both competence and objectivity evident to the auditor (see the second note in Paragraph 18). If objectivity fluctuates within an issuer's organization, the auditor may have no choice but to deem the work of little use.

6. **Will AS5 reduce expected audit costs under Section 404, particularly for smaller companies, to result in cost-effective, integrated audits?**

   I believe the overall compliance costs will continue to fall as more companies bring their Sarbanes-Oxley ("SOX") compliance efforts in-house rather than rely on outsourcing to expensive consultants. (See the May 2007 study by the Financial Executives Institute that indicates a 23% reduction in cost, though audit fees remained the same.) Small companies will have to pay their auditors more simply because more time will be spent on the two audits. The experience that external auditors have gained ought to make them more efficient and, therefore, less expensive. Auditors who do rely on more of management's work in their ICFR audit ought to cost less than those auditors who perform more extensive testing for themselves.

   A crucial area for cost reduction is the top-down, risk-based approach. See my response to the Commissioner's first question.

7. **Does AS5 inappropriately discourage or restrict auditors from scaling audits, particularly for smaller public companies?**

   I like Paragraph 13 as written because it covers all companies, not just smaller companies. Left unsaid in AS5, though I should think it is implied, is how a smaller company's growth will affect the ICFR audit. Some controls will have to change as a company grows. New layers of management may be added. This increases the scale, and the external auditor cannot take as much knowledge forward from prior years. Benchmarking automated controls can still be viable. The note in Paragraph 50 cautions auditors that inquiry alone cannot be considered sufficient evidence. This ought to be changed since benchmarking automated controls is permitted according to Paragraph B28 *et seq*. Overall, I believe AS5 does not discourage scaling the audit. (Management ought to be aware of their auditor's ability to scale the audit to their company, and meetings with their auditor to discuss scale ought to take place.)

Here are some additional observations I wish to respectfully submit to the Commission –

Paragraph 1 in AS5 ought to also be reviewed. The Board writes, "This standard establishes requirements and provides direction that applies when an auditor is engaged to perform an audit of management's assessment of the effectiveness of internal control over financial reporting ('the audit of internal control over financial reporting') that is integrated with an audit of the financial statements." [Emphasis and footnotes 1 and 2 not included] This paragraph indicates to me that the auditor is not opining on the effectiveness of a company's ICFR, but rather how company management performed their assessment of their ICFR. Moreover, it appears to open the door to two separate audits. What requirements and direction ought to be used by the auditors when they are asked to audit only the ICFR and another auditor is engaged to audit the financial statements? The first sentence in Paragraph 3 states the auditors' objective is to express an opinion on the company's ICFR effectiveness.

There is a risk inherent in Paragraph 52 that auditors could perform work too late in the fiscal year to permit remediation by management.

I thank the PCAOB for their diligence in this process and developing AS5, and urge the Commissioners to act as expeditiously as possible to ensure AS5 is in place for fiscal years ending on or after November 15, 2007 (with early adoption *strongly* encouraged).

Respectfully submitted,

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