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Regarding: PCAOB Rulemaking Docket Matter No. 021

I appreciate the opportunity to comment on the Board's Proposed Auditing Standards, "An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements," (Proposed Standard 1) and "Considering and Using the Work of Others in an Audit" (Proposed Standard 2). The integrated audit has reemphasized the importance of

(a) Managers' use of risk management in financial reporting systems, and
(b) Auditors gaining a fuller understanding of the client's systems and processes in performance of the annual audit.

The following general and specific comments are intended to address how the proposed standards guide managements and auditors.

Issue 1: **Should the audit focus on attestation to management's evaluation of the organization's internal controls, or on attestation to the quality of the organization's internal controls, or to both?**

Both attestations serve crucial roles. The Sarbanes-Oxley Act makes formal management's responsibility to assess internal controls and report on its assessment to stakeholders. This responsibility parallels management's requirement to produce periodic financial reports. Just as financial reports are audited for adherence to standards after management performs its own quality control procedures on them, management's assertion of the quality of internal controls over financial reporting should have an independent attestation as well.

In addition, the integrated audit represents an important step towards returning the annual financial statement audit towards stakeholder expectations. Historically, auditors obtained a full understanding of the client and its internal controls, and determined substantive tests based on the extent to which they could rely on the controls. In the 1990s, auditors did not strive to obtain as full of an understanding, relying more strictly on substantive tests. This approach arguably led to a decline in audit quality. AS no. 2 reestablished the importance of examining internal controls to more fully understanding the client, and to properly designing financial statement audit tests. Proposed Standard 1 should keep this requirement untouched.

AS no. 2 formally states that both attestations are equivalent in terms of the amount of effort and assurance provided (paragraph 19). It should not take significant incremental effort for the auditor to provide the attestation to management's assessment when the auditor is already examining internal controls.

Responses to specific questions:
13. Will removing the requirement for an evaluation of management's process eliminate unnecessary audit work?
It should reduce audit work only nominally. A proper audit of internal controls supporting the financial statement audit should provide sufficient evidence to attest to management's assessment as well.

14. Can the auditor perform an effective audit of internal control without performing an evaluation of the quality of management's process?
Yes, but they should perform both as part of the audit engagement.

Issue 2: **Concurrent issuance of Proposed Standards 1 and 2 implies that efficiency gains in the audit of internal controls should largely come from auditors' reliance on the work of others, especially management, rather than from proper implementation of the top-down audit approach.**

Even though the auditor would no longer render an opinion on management's assessment, the release text and both Proposed Standards give the impression that auditors should significantly increase reliance on management's assessment and supporting work to make the audit more efficient. Managers may therefore feel justified in seeking a lower-cost engagement, with less audit effort and relying more on organizational work, at the potential sacrifice of audit effectiveness. The Proposed Standards may therefore provide a means to reduce audit quality in competitive segments of the audit market. The Board should clearly emphasize that efficiency gains are expected to come primarily from use of the top-down approach. The Proposed Standards should also underscore that reliance on others, especially client personnel, should not come at the cost of audit quality.

Issue 3 (addresses question 32 posed in the release): **Paragraph 9 of Proposed Standard 1, which discusses "scaling the audit" for smaller, less complex companies, should *not* cite the SEC Advisory Committee's criteria as to what constitutes a "smaller" company.**

The Board should not suggest a set of "bright-line" criteria by which auditors would determine the scale of the audit; it is inconsistent with proper use of the top-down audit process documented in the standard. The auditor should gain a full understanding of the client, its industry, markets, operations, systems, and processes. This understanding should drive the auditor's choice of risks and controls on which to concentrate. Use of rules of thumb or shortcuts undercut the judgment of the auditor in designing an effective, yet properly-scaled audit.

Response to specific question:
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?

No. The standard lists several overly-simple generalities about small businesses compared to larger businesses. Emphasis is too strongly placed on encouraging auditors to trust inquiry and observation of top managers, and not to pursue further evidence, because of a potential lack of documentation of the controls, or of the business process in general. While top managers do tend to be closer to the operations of small businesses, they are still sufficiently busy and distant to be unable to observe much of what happens. The lack of resources available to small businesses to invest in "harder" controls makes them especially susceptible to certain risks; for example, studies have shown that many frauds occur in smaller companies. Certainly auditors should consider that controls will generally not be as strong in smaller companies. However, smaller companies should still be expected to identify their most significant risks when making control-related expenditures. The auditor's judgment, based on an understanding of the client's business and processes, should drive the scope of the controls audit.

<u>Issue 4</u> (addresses questions 27 and 28): **Proposed Standard 1 should *not* allow the auditor to rely on the work of others in performance of walkthroughs. AS no. 2's requirement that the auditor perform all walkthroughs should be kept.**

Proposed Standard 1 targets walkthroughs as another means to obtain efficiency in the integrated audit, presumably while maintaining audit quality. Walkthroughs are required for significant processes, and are now potentially conductible by others and relied upon by the auditor, with proper supervision. The requirement that walkthroughs only be performed for significant processes is sensible on its face, as long as the auditor properly assesses risks for processes. However, walkthroughs are one of the most effective inquiry and observation-based tools to learn about and confirm the auditor's understanding of client processes and controls. The auditor uses this understanding to determine the scope of further compliance tests and substantive tests. It is important for the auditor to obtain direct evidence during this phase of the audit to design high-quality audit tests. Reliance on others in performing this crucial step of the audit improperly trades off efficiency for effectiveness.

Once again, I appreciate the opportunity to comment on the Proposed Standards, and support the PCAOB's efforts to ensure audit quality.

Respectfully submitted,

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Disclaimer: The views expressed in this document are mine, and are not necessarily representative of those of my employer Grant Thornton, its partners, professionals, and staff.