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Mr. J. Gordon Seymour
General Counsel and Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, D.C. 20006-2803

PCAOB Rulemaking Docket Matter No. 021
Proposed Auditing Standard—An Audit of Internal Control over Financial Reporting That Is Integrated with An Audit of Financial Statements and Related Other Proposals

Dear Mr. Seymour:

Ernst & Young LLP is pleased to comment on the PCAOB's proposed auditing standard on auditing internal control over financial reporting (the "Proposed Standard") and related other proposals. We strongly agree with the Board's observations that auditing and reporting on internal control over financial reporting has produced significant benefits and protections to investors by fostering greater focus on corporate governance, enhanced audit committee oversight, improvements in the quality and efficiency of important corporate processes and controls, higher quality financial reporting, and enhanced transparency.

In our view, the continued provision of a single standard for conducting an audit of internal control over financial reporting that requires auditors to annually obtain reasonable assurance about the design and operating effectiveness of internal controls is the right result for investors, companies, and the capital markets. We believe the Proposed Standard is scalable for audits of companies of all sizes and do not believe a different set of requirements for audits of smaller public companies is in the public interest. The Proposed Standard will help auditors of accelerated filers that already have been through the most challenging aspects of initial Section 404 implementation to further improve their processes. Additionally, the Proposed Standard will be particularly helpful to the auditors of those issuers that have not yet implemented Section 404.

We support the Board's goals to better align the auditor's efforts in performing audits of internal control over financial reporting with the significant benefits they have been shown to provide, while maintaining the integrity of the overall audit process. We support the Board's objectives of focusing the auditor on the matters most important to internal control, eliminating unnecessary procedures, providing auditors the opportunity to incorporate knowledge obtained during past audits, and simplifying and shortening the standard.

We appreciate that the Proposed Standard is more principles-based and provides for wider use of professional judgment. We believe this will permit auditors to focus on matters most important to a company's internal control over financial reporting and its financial statements and to tailor the audits to the particular circumstances. This will significantly aid the auditor's ability to scale the audit to reflect the size and complexity of the company.

Several areas of the Proposed Standard provide for broader use of professional judgment, ranging from assessment of risk and the effect on the auditor's scope and testing to the evaluation of control deficiencies. A natural outcome of principles-based auditing standards that provides for wider use of professional judgment will be that auditing firms and individual auditors may not always interpret and apply such standards uniformly or agree on how they should be applied in a particular circumstance. Accordingly, we strongly believe that PCAOB inspectors must come to respect the range of possible judgments that auditing firms and individual auditors may appropriately make under principles-based standards and the alternative and equally acceptable approaches and methods they may choose to employ. Constructive discussions and challenges as to the scope and nature of procedures chosen are always an appropriate and needed part of the inspection process, but the inspector's judgment cannot be viewed as usurping that of the auditor as long as the principles outlined in the auditing standards have been complied with in a reasonable and good faith manner.

The following are summary comments regarding certain technical aspects of the Board's proposals.

Addressing Efficiency in the Performance of an Integrated Audit
The Proposed Standard has several provisions that address audit efficiency. We are committed to the objective of conducting an efficient as well as effective audit, but we are very concerned that the inclusion in an auditing standard of provisions relating to efficiency, including presumptively mandatory performance requirements such as the one in paragraph 3 that "the auditor *should* (emphasis added) select for testing only those controls that are important to the auditor's conclusion …," may detract from the overarching objective of the standard, which is to provide guidance for auditors for performing a high quality audit. Under the Proposed Standard, an auditor might perform audit procedures that the auditor believed were appropriate in the circumstances because they were relevant to the overall scope and objective of the audit. But he or she could nonetheless violate PCAOB auditing standards because, in the view of others, the approach he or she took was not the most efficient testing approach possible.

We are concerned that as drafted the Proposed Standard could be viewed by some as making efficiency as important a goal as audit effectiveness. We believe that would not be in the public interest. While efficiency is certainly important and we are committed to it in our work, performing a highly effective audit is paramount and essential to meeting the needs of investors and the markets. We suggest that the PCAOB make revisions in the final standard to make it clear that first and foremost the auditor must be concerned with effectiveness as the measure of audit quality. Part of the message must also be that if auditors faithfully follow the principles in the Proposed Standard and execute a highly effective audit, they will not be deemed to have violated PCAOB auditing standards if someone after the fact believes a more efficient approach might have been taken. We are unaware of any prior actions by auditing standard setters in the U.S. or internationally to describe the maximum amount of work that an auditor should perform without risking a violation of professional standards that could result in sanctions or litigation.

Management's Assessment
We encourage the Board to acknowledge in the final standard the significant effect that the nature and quality of management's assessment can have on the scope of the integrated audit, including a direct bearing on the auditor's consideration and use of the work of others. We also encourage the Board to acknowledge in the final standard that, because of this important effect, the auditor will need to obtain an understanding of management's process as a starting point to understanding the company's internal control, assessing risk, and determining the extent to which he or she will use the work of others.

We believe it is important not to understate the effect that meaningful collaboration between management and auditors has on the efficient conduct of an audit. We believe management is generally interested in determining both how to complete its assessment and how the auditor completes its audit of internal control over financial reporting in a quality, yet cost-effective manner. In following the SEC proposed guidance for its assessment, management could face a number of decisions among competing cost-efficient approaches. For example, management may need to decide whether to gather evidence through self-assessment by those responsible for the design and operation of the controls, or instead gather evidence through re-performance of controls by more competent and objective internal audit personnel, with the latter alternative potentially affording the auditor the ability to use the work to a greater degree.

Considering the Effect of Company-Level Controls
We agree that an evaluation of company-level controls is an important part of a top-down, risk-based approach and should occur early in the audit. However, we are concerned that the Proposed Standard potentially overstates the frequency with which company-level controls can be directly linked to relevant assertions to address the risk of material misstatements in the financial statements. In our view, the final standard should acknowledge that in many circumstances company-level controls only indirectly relate to relevant assertions and do not operate in a manner that would be sufficient to address the risk of material misstatement to specific accounts and disclosures in the financial statements. If the Board believes company-level controls can more frequently be linked to relevant assertions, we would welcome examples that illustrate the linkage and the benefit that could be derived from them in determining the nature, timing, and extent of testing of lower-level controls.

Risk Assessments
We support the inclusion of a core principle that a direct relationship exists between the degree of risk that a material weakness could exist in a particular area of the company's internal control over financial reporting and the amount of audit attention the auditor should devote to that area. However, we are concerned that the Proposed Standard implies that risk needs to be assessed and documented at multiple levels, including a formal assessment of risk at the control level.

Auditors are not currently required to assess risk at the control level for audits of financial statements, so we are unclear as to the need for, or the benefit of, this additional layer of risk assessment for the audit of internal control over financial reporting in an integrated audit. Similar to other auditing firms, we require a control risk assessment at the assertion level, which, in our view, provides the focus for evaluating whether identified controls adequately address the risk of material misstatement of the financial statements. We also believe that an assertion-level risk assessment provides an appropriate basis for considering an effective and efficient strategy for testing controls. Therefore, we believe that a requirement to assess risk at the control level is unnecessary and would not improve audit quality. In addition, we strongly believe the effort and documentation required to make and support a formal assessment of risk at this level would be labor-intensive, potentially costly and incremental to the effort that was required by PCAOB Auditing Standard No. 2 (AS2).

Using the Work of Others
We believe the Proposed Standard on auditing internal control over financial reporting removes the barriers that previously existed in AS2 to the effective use of the work of internal auditors and others by eliminating the principal evidence provision and providing that auditors can supervise the work of others who provide direct assistance to the auditor in the performance of a walkthrough. We believe that it is unnecessary to supersede AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, with the separate proposed standard on considering and using the work of others. We believe AU section 322 continues to provide relevant guidance to auditors and therefore recommend that it be retained. However, the Board should consider two conforming amendments to AU section 322 to (i) clarify that the auditor may use of the work of internal auditors in conducting an audit of internal control over financial reporting, and (ii) allow the auditor to use the work of management and others in assessing control risk for the audit of the financial statements.

In our view, with the conforming amendments suggested above, AU section 322 would provide an appropriate single framework for considering the use of the work of others in both the audit of the financial statements and the audit of internal control over financial reporting. Accordingly, we do not believe that the separate proposed auditing standard is necessary. It is our belief that the proposed standard expands the definition of relevant activities to include tests providing evidence about potential misstatements of the company's financial statements performed by those not acting in an internal audit capacity, which we believe could lead to the inappropriate use of the work of others in a manner that could reduce audit quality.

In the attachment to this letter, we also have included our responses to each of the Board's discussion questions either individually or in summary form related to specific topics.

We would be pleased to discuss our comments with members of the Public Company Accounting Oversight Board or its staff.

Very truly yours,

Ernst & Young LLP

A. Focusing the Audit on the Matters Most Important to Internal Control

1. 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?*

We believe that the Proposed Standard clearly describes how to use a top-down approach. We also believe the Staff's efforts to reorganize the standard to follow the sequential flow of an audit is helpful. However, we believe the Proposed Standard should provide a more balanced discussion of the potential link of company-level controls to relevant assertions and their effect on controls at the process, transaction, or application level.

We believe that the Proposed Standard suggests a stronger link between company-level controls and the nature, timing, and extent of the auditor's tests of controls that operate at the process, transaction, or application level than has been observed in practice over the years. Moreover, we believe that misperceptions could be prevented if it were made clear within the final standard how the varying types of company-level controls would be expected to influence testing of other controls.

While we agree that company-level controls vary in precision, we are concerned that the Proposed Standard leaves the impression that all the categories of company-level controls listed in paragraph 18 can be directly linked to relevant assertions or would be effective as monitoring controls in identifying possible breakdowns in lower-level controls. In our view, the final standard should acknowledge that in many circumstances the categories of company-level controls listed in the Proposed Standard only indirectly relate to relevant assertions and do not operate in a manner that would be sufficient to address the risk of material misstatement to specific accounts and disclosures in the financial statements. In our experience, company-level controls frequently do not directly link to relevant assertions, and it is difficult to reflect their indirect benefit in designing the nature, timing and extent of tests of process, application, or transaction level controls. If the Board believes the categories of company-level controls listed in the Proposed Standard can be linked more frequently to relevant assertions, we would welcome examples that illustrate the linkage and the benefit that could be derived from them in determining the nature, timing, and extent of testing of lower-level controls.

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

We believe the Proposed Standard appropriately emphasizes the importance of identifying and testing controls designed to prevent or detect fraud. However, we believe the understanding of a company's fraud programs and controls can best be leveraged when it is undertaken early in a top-down approach to the integrated audit. Accordingly, we recommend bringing paragraph 45 of the Proposed Standard forward to the "Identifying Company-Level Controls" section of the standard. We believe this change in the final standard also would help to clarify that fraud programs and controls are inter-related with the overall system of internal control over financial reporting.

We observe that the Proposed Standard has broadened the definition of company-level controls to include controls over management override without providing any further direction. Accordingly, we believe the Proposed Standard would benefit from an expanded discussion of the evaluation of the risk of management override and company-level controls. This expanded discussion could include, among other things, the auditor's evaluation of the risk of management override (i.e., incentives or pressures, opportunities, and rationalizations) and the types of actions generally taken by management in response to the risk of management override (i.e., controls or other actions taken by the company in response to identified risks).

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

Yes. In our experience, a top-down approach aids the auditor in identifying controls important to the audit. However, auditors might conclude differently as to the relative importance of individual controls or the combination of controls to test to address identified risks.

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?*

See response to question 1. We agree that an evaluation of company-level controls is an important part of a top-down, risk-based approach and should occur early in the audit. However, we believe the Proposed Standard should provide a more balanced discussion of the potential link of company-level controls to relevant assertions and their effect on controls at the process, transaction, or application level. In our experience, company-level controls in most instances do not directly link to relevant assertions, and certainly not with the regularity that might be inferred from the language in the Proposed Standard.

2. 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?*

We continue to be supportive of the Board's May 16, 2005 guidance and concur with the inclusion of the core principles of such guidance in the Proposed Standard, including the notation that a direct relationship exists between the degree of risk that a material weakness could exist in a particular area of the company's internal control over financial reporting and the amount of audit attention the auditor should devote to that area.

However, we believe the Proposed Standard should clarify the risk assessments expected to be made and documented within the top-down approach. Specifically, we are concerned that the Proposed Standard implies that risk needs to be assessed and documented at multiple levels, which might result in confusion and create specific performance requirements resulting in unnecessary additional effort. We are particularly concerned about the requirement to make a formal assessment of risk at the control level. Auditors are not currently required to assess risk at the control level for audits of financial statements, so we are unclear as to the need for, or the benefit of, this additional layer of risk assessment for the audit of internal control over financial reporting in an integrated audit. Similar to other auditing firms, we require a control risk assessment at the assertion level (after determining and documenting for each control whether it is effective), which, in our view, provides the focus for evaluating whether identified controls adequately address the risk of material misstatement of the financial statements. We also believe that an assertion-level risk assessment provides an appropriate basis for considering an effective and efficient strategy for testing controls. Therefore, we believe that a requirement to assess risk at the control level is unnecessary and would not improve audit quality.

We strongly believe the effort and documentation required to make and support a formal assessment of risk at the control level would be labor-intensive, potentially costly and incremental to the effort that was required by AS2. We further believe the nature, timing, and extent of testing of the controls selected for testing that is documented in the audit program implicitly documents the auditor's consideration of the risk factors associated with each respective control.

Additionally, certain references throughout the Proposed Standard have the potential to create confusion for auditors. For example, paragraph 3 and paragraphs 41 through 44 of the Proposed Standard indicate the risk of misstatement should be considered for each relevant assertion. Paragraph 8 uses the terms "degree of risk" and "a particular area of the company's internal control," while paragraph 51 requires that for each control selected for testing, an assessment be made of "the risk that the control might not be effective and if not effective, the risk that a material weakness would result" and references the "risk associated with a control." We urge the Board to more clearly distinguish the various risk assessments described in the final standard and to clarify the role of each in an audit that is both top-down and risk-based.

While we believe we understand the Board's intention, we believe that the statement in paragraph 8 of the Proposed Standard that "the auditor should focus the majority of his or her attention on the areas of greatest risk to substantially decrease the opportunity for a material weakness to go undetected" is problematic and needs to be revised. Taken literally, an auditor could be determined to be in violation of professional standards if in the conduct of an audit the audit engagement team spent more than 50% of the total engagement time on areas of the audit that were not “of greatest risk.” As drafted, the Proposed Standard would establish a requirement for audits that 51% or more of the engagement hours be spent on areas of greatest risk and 49% or less of the engagement hours on all other areas of the audit. We do not believe this was the Board’s intention and recommend removal of the words “the majority of” from this sentence.

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

We agree with the general principle that a correlation should exist between the risk of a material weakness if a control failed to operate effectively and the amount of audit evidence needed to support the operating effectiveness of that control. Accordingly, we believe the auditor can vary the nature, timing, and extent of testing of controls based upon the consideration of various risk factors, including those outlined in paragraphs 52 and 66 of the Proposed Standard. In addition to these risk factors, we also believe the auditor should consider the importance of a control in determining the appropriate testing strategy for that control. This consideration includes whether the control addresses multiple “what could go wrong” questions for a single assertion or addresses multiple assertions related to one or more significant accounts or disclosures. In these situations, we generally do not believe that the performance of a walkthrough alone would be sufficient to test the operating effectiveness of the control. On the other hand, in circumstances where a control exists within a lower-risk area, is deemed to be low risk based on the factors in paragraphs 52 and 66 of the Proposed Standard, and was tested and determined to be effective in prior years, the performance of a walkthrough might be sufficient to test the design and operating effectiveness of the control. Overall, we would not expect that auditors will frequently conclude in many areas of the audit that only a walkthrough is sufficient for concluding on the design and operating effectiveness of controls.

3. 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?*

In our view, the proposed definition of “significant” could be applied in practice, but would require the use of judgment in determining whether a control deficiency relates to matters that are important enough to merit attention by those responsible for oversight of the company’s financial reporting. We agree with the use of judgment in determining significance in this context, but it is uncertain how this change will affect the number of significant deficiencies communicated as a result of the integrated audit.

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?*

Because the audit of internal control and the audit of the financial statements are integrated activities, we are not surprised that a large number of material weaknesses reported to date were identified when material misstatements were detected during the audit. However, we do not believe that the underlying control deficiencies contributing to these material weaknesses necessarily suggests that the material weakness existed, or could have been detected, at an earlier date.

We agree that investors are better served by early identification of material weaknesses that have not yet resulted in misstatements. We believe the focus of the Proposed Standard on evaluating the control environment, anti-fraud programs and controls, and the period-end financial reporting process are appropriate measures to aid auditors in earlier identification of material weaknesses, even in the absence of material misstatements. However, such procedures alone would not improve the earlier identification of material weaknesses.

We believe that management and auditors must pay appropriate attention to controls at the process, transaction or application level, and the benefits of an effective system of internal control over financial reporting in preventing and detecting material misstatements, including those related to fraud. Root-cause analysis of exceptions identified in control testing also can lead to earlier identification of material weaknesses. We have a general concern that any significant reductions in the interactions with process owners through process, transaction or application level control testing potentially could adversely affect the early identification of deficiencies and thus the ability of management to take action to prevent material weaknesses in advance of an actual material 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?*

It is difficult to predict whether the proposed changes to the definitions will have a measurable reduction in the amount of auditor effort in analyzing deficiencies. We believe that auditors already are, in effect, applying the “reasonable possibility” threshold in their evaluation of deficiencies because the Board’s November 30, 2005 Report on the Initial Implementation of Auditing Standard No. 2 indicated that “more than remote” had the same meaning as “at least reasonably possible.” However, paragraph 70 of the Proposed Standard states the auditor must evaluate the severity of each control deficiency that comes to his or her attention, so auditors will need to apply at least some degree of effort and judgment when analyzing each deficiency that has been identifed.

4. 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?

In our view, each of these situations requires an analysis of the specific facts and circumstances. We believe that our audit engagement teams presently are basing determinations of whether or not material weaknesses exist based on the specific facts and circumstances. It has been our experience, however, that a material weakness often is found to exist when one of these strong indicators is present. We believe the list of strong indicators in both AS2 and the Proposed Standard are appropriate and our experience has demonstrated that these conditions are strong indicators of a material weakness for a good reason, i.e., in most cases the underlying control deficiency or deficiencies rise to the level of a material weakness when evaluated under the likelihood and magnitude framework. However, we believe removing the presumption that the circumstances described are indicative of at least a significant deficiency helps to eliminate the view expressed by some that auditors are too quick to conclude that a material weakness exists. We expect that auditors will continue to apply their professional judgment in evaluating the specific facts and circumstances, and in certain situations might conclude that no control deficiency exists.

5. Clarifying the Role of Materiality in the Audit

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

No.

6. Clarifying the Role of Interim Materiality in 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?

We strongly urge the Board to remove the reference to interim financial statements in the definitions of significant deficiency and material weakness. The reference to interim financial statements apparently continues to cause confusion for some regarding the scope of an integrated audit. Additionally, the auditor is unable to evaluate relevant factors (especially qualitative factors) about the potential effect of control deficiencies on interim financial statements because the auditor did not audit those statements and therefore does not have the knowledge that would have been gained from those audits. For these reasons, the reference to interim financial statements is potentially misleading to investors and should be eliminated.

However, we do not believe that the scope of integrated audits would be affected if the reference to interim materiality were removed from the deficiency definitions, because scope is determined with respect to the full-year, annual financial statements.

B. Eliminating Unnecessary Procedures

1. Removing the Requirement to Evaluate Management's Process

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

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

We support the removal of the requirement for the auditor to provide a separate opinion on management's assessment. We are aware that the issuance of this separate opinion has been incorrectly interpreted by some parties as the expression of an opinion on management's assessment process, rather than its intended purpose of acknowledging whether or not the auditor is in agreement with management's assertion about the effectiveness of the company's internal control over financial reporting. Therefore, we believe that providing an opinion only on the effectiveness of internal control will more clearly communicate the scope and results of the auditor's work. However, while potentially less confusing, we do not believe that eliminating the auditor's separate opinion on management's assessment will have a measurable reduction in audit effort. We do not believe that our audit engagement teams currently are spending significant incremental time and effort evaluating management's assessment process.

We observe that paragraph 1 and the introductory paragraph of the illustrative report in paragraph 96 of the Proposed Standard indicate the auditor is auditing management's assessment. We believe these references might continue to suggest the auditor is auditing management's assessment process and urge the Board to add a footnote to the final standard to explain why this reference is necessary in the introductory paragraph of the auditor's report on internal control over financial reporting. We believe this additional clarification would help to avoid any inference that the auditor is auditing management's assessment process.

On page 16 of the Board's proposal release, it states "Under the proposed standard, an auditor still would need to obtain an understanding of management's process as a starting point to understanding the company's internal control, assessing risk, and determining the extent to which he or she will use the work of others." We strongly agree with the Board's statement and believe that the auditor's responsibility to obtain an understanding of management's process should be included in the final standard as part of planning the audit. We believe the auditor can perform an effective audit of internal control without evaluating management's assessment process, but the quality of management's process has a direct bearing on the auditor's risk assessments and his or her consideration and use of the work of others.

We also believe the Board should consider including in the Proposed Standard a discussion of the auditor's responsibilities if the auditor believes that management's assessment is so deficient that, in the auditor's judgment, it does not meet the requirements under the Sarbanes-Oxley Act of 2002 and the SEC's rules and regulations for implementing Section 404 of the Act.

2. Permitting Consideration of Knowledge Obtained During Previous Audits

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

We believe the Proposed Standard appropriately incorporates the consideration of cumulative knowledge obtained through past audits through the inclusion of paragraphs 65 through 69 under the section "Special Considerations for Subsequent Years' Audits." However, we also believe that this knowledge is only one of many considerations that weigh into a risk assessment. Accordingly, we encourage the Board to consider a minor revision to paragraph 65 to state "the auditor should incorporate knowledge obtained during past audits he or she performed of the company's internal control over financial reporting as a part of the decision-making process for determining the nature, timing and extent of testing necessary."

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?

Refer to our response to question 6.

3. 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?

We believe a risk-based approach for the scoping of a multi-location engagement that relies on auditor judgment is consistent with the overall direction of the Proposed Standard and is fundamentally sound. However, elimination of all of the guidelines currently in AS2 might provide the perception that the auditor should, in all instances, being doing less work. We recommend that the Board describe in the final standard the risk factors the auditor should consider in determining the locations or business units that present specific risks and therefore should be included in the scope of the audit. Among other factors, the relative size of the location or business unit, its history of unusual or complex transactions, prior audit findings, the risk of fraud, and management's own assessment of potential risk are important factors the auditor might consider to guide his or her professional judgment.

4. Removing the 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?

As stated in our summary comments, we are supportive of the Board's efforts to remove barriers to the appropriate use of the work of others in integrated audits. However, we believe that aspects of the Board's Proposed Standard on considering and using the work of others pose the potential unintended consequence of undermining audit quality. The Proposed Standard expands the definition of relevant activities to include tests providing evidence about potential misstatements of the company's financial statements performed by those not acting in an internal audit capacity, which we believe could lead to the inappropriate use of the work of others and reduce audit quality. Another potential unintended consequence of the proposed requirements is to increase the effort by auditors to seek, and then to document, activities by others that eventually have no significant effect on the scope of the auditors' work.

Therefore we believe the Board should not issue a new, separate standard for using the work of others. Alternatively, we believe that eliminating the principal evidence provision in AS2 and specifying that auditors may supervise the work of others who provide direct assistance to the auditor in the performance of a walkthrough, among other changes to the Proposed Standard, and retaining AU section 322, with certain conforming amendments, would better meet the Board's objectives, while at the same time not reducing audit quality or efficiency.

We further believe that this alternative would benefit auditors of foreign private issuers that are required to report under both International Standards on Auditing (ISAs) and PCAOB standards. We are concerned about any course of action that could potentially create confusion for auditors of foreign private issuers with respect to their consideration of the work of others. ISA 610, *The Auditor's Consideration of the Internal Audit Function*, describes the requirement for the auditor to obtain an understanding of the internal audit function and consider whether the activities of the internal audit function are relevant to planning and performing the audit. In our view, these requirements are consistent with extant AU section 322. We therefore believe that retaining AU section 322, with certain conforming amendments, would promote harmonization of the ISAs and PCAOB auditing standards and help to avoid any confusion about requirements for auditors reporting under both sets of standards.

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?

This question is answered as part of our response to Question 19.

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

As discussed above, we believe a new standard on considering and using the work of others is unnecessary and that the Proposed Standard on auditing internal control, along with conforming amendments to AU section 322, are appropriate. We do not believe that the proposed requirements for the auditor to understand in greater detail the relevant activities performed by others will improve audit quality to any appreciable degree, yet potentially will add incremental documentation efforts.

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

No. We support the Board's removal of the term "principal evidence" but recommend that the Board make appropriate conforming amendments to AU section 326, *Evidential Matter*, to indicate that the auditor must obtain sufficient competent evidence in support of his or her opinion in an audit of internal control over financial reporting.

23. Does the proposed standard provide an appropriate framework for evaluating the competence and objectivity of the persons performing the testing? Will this framework be sufficient to protect against inappropriate use of the work of others? Will it be too restrictive?

The framework for evaluating the competence and objectivity of the persons performing the testing included in the Proposed Standard on considering and using the work of others is similar to the framework provided in AU section 322. We are supportive of conforming amendments, as necessary, to AU section 322 to reflect this framework.

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

This question is answered as part of our response to Question 23.

25. What will be the practical effect of including, as a factor of objectivity, a company's policies addressing compensation arrangements for individuals performing the testing?

We believe the broad inclusion of this factor may entail additional documentation requirements with little other practical effect. We believe this additional consideration regarding objectivity is likely to have a low level of significance except in the rare circumstances where compensation arrangements are determined by the subject matter being tested (e.g., compensation arrangements for the individual are based upon growth in revenues, with revenues as the subject matter) or the outcome of the testing procedures (e.g., compensation arrangements for the individual are based on there being no or few deficiencies).

5. 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?

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?

Based on our experience, a change in the requirement to perform a walkthrough only with respect to each significant process, as opposed to each major class of transactions, is not likely to significantly reduce the number of walkthroughs being performed in these areas. Further, while some routine classes of transactions typically relate to the same significant process, these routine classes of transactions often have significantly different risks. As a result, we believe the actual reduction in the number of walkthroughs to be completed under the Proposed Standard is not likely to represent a significant percentage of the walkthroughs currently being performed.

We are supportive of the proposal allowing for the use of the work of others when they provide direct assistance in performing walkthroughs. However, it has been our experience that few companies have performed walkthroughs as part of management’s assessment of internal control over financial reporting. Accordingly, in many cases the resources necessary to provide direct assistance to the auditor in the performance of walkthroughs will be incremental to a company’s existing resources and planned efforts.

C. 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?*

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

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?*

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

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?*

We are strongly supportive of the Board's efforts to address the unique challenges faced by smaller public companies. We agree that the auditor should evaluate the size and complexity when planning and performing the audit of internal control, and believe that such evaluations are regularly being made in practice now for audits of smaller companies. Evaluations of size and complexity affect materiality and scoping decisions, including the determination of significant accounts and relevant assertions and multi-location scoping decisions; the types of controls that are identified; and the nature, timing, and extent of the auditor's testing procedures. Additionally, we believe the attributes common to smaller and less complex companies listed in the Proposed Standard are appropriate and further believe that paragraph 12 of the Proposed Standard appropriately describes the aspects of the audit that might be affected.

We do not believe the market capitalization and revenue thresholds by themselves are determinative in evaluating risk and complexity in planning an integrated audit. We believe that the evaluation of size and complexity should be considered in light of each company's individual facts and circumstances. In our view, the thresholds in the note to paragraph 9 of the Proposed Standard focus only on size without regard to complexity, thereby implying that the audit could be scaled simply based on quantitative characteristics. We do not believe these simple quantitative thresholds should drive the auditor's performance requirements, but rather a risk assessment that reflects the uniqueness of each company and determines the tailored scope of each audit.

Further, we strongly believe that the applicability of the performance requirements in paragraphs 9 through 12 of the Proposed Standard under the caption "scaling the audit for smaller companies" should be clarified. The performance requirements should only be applicable to those companies meeting the definition of "smaller companies," as the caption titling suggests, and as provided in the footnote to the Note to paragraph 9. Requiring auditors to consider the performance requirements of paragraphs 9 through 12 for every audit would create unnecessary and incremental audit effort for the significant majority of accelerated and large accelerated filers.

We also strongly believe the inclusion of the specific performance requirement in paragraph 9 that the auditor “document how the size and complexity of the company affected the audit” is unnecessary, and will create an unnecessary documentation requirement if left without modification. Paragraph 9 already states the auditor is required to evaluate the size and complexity of the company and that such evaluation should have a pervasive effect on the audit. Therefore, documenting the specific effects would seem to be an exercise with little, if any, value, but one that would require unnecessary time and effort. Should this specific documentation requirement be retained, we believe the requirement should only be applicable for those companies meeting the definition of “smaller companies” referred to in paragraph 9. Additionally, if retained, we believe the final standard needs to be much clearer as to the expectations for how an auditor documents how size and complexity affected an audit.

Finally, we are very supportive of the PCAOB’s efforts to develop further guidance for the performance of audits of smaller companies.

D. Simplifying the Requirements

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?*

No. We believe the requirements of proposed rule 3525 are sufficient as drafted.

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 experience, significant planning efforts for integrated audits and management assessments occur in the first and second quarters of the fiscal year for a majority of accelerated filers. Accordingly, we recommend that the Board not make the final proposals mandatory for calendar 2007 audits. However, we believe early adoption should be permitted.