
From: Larry Hightower, CPA [mailto:LHighto831@comcast.net]
Sent: Monday, February 26, 2007 5:08 PM
To: Comments
Subject: FW: PCAOB Rulemaking Docket Matter No. 021

From: Larry Hightower, CPA [mailto:LHighto831@comcast.net]
Sent: Monday, February 26, 2007 4:59 PM
To: 'comments@pcaobus.or'
Subject: PCAOB Rulemaking Docket Matter No. 021

Laura Phillips
Deputy Chief Auditor
Public Company Accounting Oversight Board
1666 K Street
Washington, D.C. 20006

SUBJECT: Comments on PCAOB Proposed Auditing Standard 5

Dear Ms. Phillips:

I have reviewed ***PCAOB Proposed Auditing Standard 5.*** Please review the following comments which are referenced to the noted subdivisions in the draft document. I hope that my comments contribute to the discussion, debate and release of a standard that promotes accurate, timely and transparent financial reports that allocate the most capital, at the best rates, to those firms that are adding genuine economic value to its beginning capitalization.
Very Truly Yours,

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Comments on Public Company Accounting Oversight Board Proposed Auditing Standard 5

II. Significant Changes to the Standard (Page 4)

The Board decided to propose a new standard on auditing internal control rather than revise **PCAOB Auditing Standard 2**. Unless, **AS 2** was irretrievably flawed in all significant areas, it would have been better to revise **AS 2** to address legitimate concerns about auditing effectiveness, efficiency and cost.

2. **Emphasizing the Importance of Risk Assessment (Page 7 and 8)**

In **Paragraph one**, under this caption, it is stated that "From the auditor's initial evaluation of material risk at the company level, the auditor should continually adjust his or her procedures to reflect information that the auditor has learned, including experiences from both the audit of internal control and the audit of the financial statements."

My question on the above excerpt is this: material to what? Can a "material weakness" be assessed at the company level? As I will discuss later, the word
"material" implies a dollar threshold which further implies an assessment at the financial statement, account and transaction level.

In **Paragraph four**, the statement "In contrast, the proposed standard directs the auditor to consider the results of substantive audit procedures performed in the financial statement audit when determining the overall risk related to a control" appears to be backwards. The risk associated with a control determines the nature of substantive testing. In other words, the higher the level of risk associated with a control (i.e. lack of approvals of large expenditures could lead to errors or fraud), the more substantive testing that needs to be done to ensure that an account balance is accurate

Page 9 – In **Paragraph one**, the sentence "The Board believes that the existing framework in **AS No. 2**, which describes significant deficiencies and material weaknesses by reference to the likelihood and magnitude of a potential misstatement, is fundamentally sound" is probably the main reason for all of the confusion around this issue. For example, **Webster's** Dictionary defines the adjective ***significant*** as "important'. Webster's defines the word ***material*** as "having real importance or great consequences".

So, it should be clear that significant deficiency and material weakness describe the same thing, even in the context of financial auditing. The Board needs to drop, not re-articulate the term ***significant deficiency***. The statement in **Paragraph two**, on **Page 10**, that "the Board is, therefore, proposing to re-articulate the definition of significant deficiency to better establish the threshold of what the Board believes is important enough to be identified as a significant deficiency" is a good example of why the term should be eliminated.

The issue is whether an examination of internal controls reveals deficiencies (i.e. lack of compliance, inadvertent or deliberate errors or omissions) that could impact financial statement accounts in a way that could influence the decisions of users. These would be material deficiencies. Drawing a non-existent distinction between significant deficiencies and material weaknesses is the source of the confusion.

If a "weakness" does not result or cannot result in a material misstatement, is really a material weakness? Also, if a control deficiency is significant (important), then, by definition, it's material. If it's not material, then it's not significant.

Relative to the confusion over thresholds, accounting and audit professionals should not have to split these kinds of hairs (**Page 9, last two sentences in Paragraph two):** "The definitions in **AS 2** refer to a "more than remote likelihood of a misstatement occurring. In accordance with **FASB Statement No. 5**, the likelihood of an event is "more than remote" when it is either "reasonable possible" or "probable". For example, if a potential misstatement is ***not remote***, then it must be either ***reasonably possible*** or ***probable.***

In the ***21st Century***, where statistical science is not only highly developed, but accessible to even the mathematically challenged via graphing calculators and easy to use PC based software, the Board should consider requiring that management establish and auditors attest to **subjective probabilities** that support the thresholds for the likelihood of material misstatements in financial statements. For example, note the following suggestions:

Remote	0 to 40%
Reasonable Possible	41 to 69
Probable	70 to 95%

These model subjective probabilities could be based on the opinions of experienced people in the company and supported by experts from other companies, industry experts, and other parties. The key point is management is forced to assign subjective probabilities to their estimates of the likelihood of future events that could have a material impact on financial statements.

1. Removing the Requirement to Evaluate Management's Process (Page 15)

The statement in **Paragraph two**, "Many commentators have expressed concern over these requirements. Some believe that, under **AS No. 2,** the auditor performs work unnecessary to achieve intended benefits by directly testing controls and evaluating management's evaluation process." My response to this statement is as follows:

The management of a company is responsible for internal control over corporate transactions and the related summary of these transactions in financial statements. Since SEC rules implementing Section 404 of the Act require management to evaluate and report on the effectiveness of internal control, the Act and the professional standards of the Board have to require auditors to examine and issue an opinion on management's review of internal control and the related statements of financial position, results of operations and cash flows.

For some strange reason, this discussion strongly implies that management's review and report on internal control has absolutely nothing to do with the production of financial statements. Unless I'm missing something, management's review of internal control should be the starting point for every annual audit. The auditor should review and test management's assessment of internal control and use the results as a basis for planning the audit.

Note: I have run out of time. I haven't finished my analysis of the AS 5 Proposal, but will send you what I have by the deadline. I will complete my analysis and send in the comments even though it will be after the deadline.