February 23, 2007

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 20006-2803

Reference: PCAOB Rulemaking Docket Matter No. 021

Dear Sir or Madam:

Thank you for this opportunity to provide comments on the PCAOB's proposed standard An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements (the proposed audit standard). The respective efforts by the SEC, PCAOB, external audit firms, and filers to enhance the effectiveness and efficiency of the audit of Internal Control over Financial Reporting (ICFR) is commendable.

It is now apparent that the initial implementations of SOX 404 were indeed inefficient (and of questionable effectiveness). Too much of the wrong work was completed, while possibly not adequately addressing the significant risks to ICFR. This has continued to be carried forward, at many companies, in the years subsequent to the initial implementation.

Further, initial implementations did not place the proper priority on the types of risks that led to the enactment of the Sarbanes Oxley Act in 2002 (including issues with the control environment, fraud at the senior level, and management override). The reason for this was that Auditing Standard No. 2 – An Audit of Internal Control over Financial Reporting Performed in Conjunction with An Audit of Financial Statements (AS2) focused the audit of ICFR at too detailed a level and did not provide for the proper reliance on a risk assessment of ICFR. Auditors felt justifiably compelled to audit to the most conservative clause within AS2. Thus, although AS2 contained the appropriate principles, there was lack of sufficient clarity or directive for the auditor. What were interpreted as the rules of AS2 directed the auditor on a significantly different path (i.e. auditing to the most conservative clause or trying to audit everything) rather than focusing on risk. When risk was introduced to the auditors' approach, it generally manifested solely in determining the nature, timing and extent of testing of controls (controls that probably should not have been in scope in the first place).

The direction provided by the SEC and the PCAOB, in May 2005, seemed to present the opportunity for auditors to rethink their approach. It has been stated that management also should embrace the new approach. However, the practical reality is that any filer that did try to embrace a top-down, risk-based approach did so at its own peril. There would be no recourse for filers in the situation where management chose to embrace the top-down, risk-based approach and the auditor disagreed philosophically. Filers would then be stuck in a situation that would lead to significantly greater external audit fees, or worse, deficiencies in its process of evaluating ICFR.

The current proposals from the SEC and the PCAOB offer meaningful direction and the opportunity for filers to implement Section 404 in a more meaningful top-down and risk-based approach. The proposals also alleviate some of the pressures placed on the external auditors who had interpreted the prior standard to create an audit to the most conservative clause.

The only significant barrier that I see to successful implementation of this new audit standard is clarification of the definition of reasonable possibility as exists throughout the standard and in the definition of <u>Relevant Assertion</u> ("…a financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated.")

Without clear guidance from the PCAOB (other than deferring to SFAS5 and other authoritative literature that defines "reasonably possible.") on the intended order of magnitude of this one phrase, the audit profession could elect to interpret (reinterpret) its definition, reducing the bar to such a low level that risk assessment will not be a meaningful exercise. If that occurs, the efforts of the SEC and PCAOB to clarify and improve the standards may have been in vain. There will be limited improvements in the effectiveness and efficiency of the audit of ICFR.

AS2, section 9 defined more than remote to be "…either reasonably possible or probable" per the meaning of evaluating the likelihood of a loss contingency in SFAS5. The auditing profession, perhaps because this was a new term, perceived more than remote to be the boundary **<u>between</u>** remote and reasonably possible. In quantitative terms, one Big 4 firm stated that this represented more than a 5-10% probability of occurance in its interpretation of how to implement AS2.

Comments from more than one of the major audit firms have indicated that their belief is that the proposed audit standard does not change this conceptual threshold. Further, one Big 4 firm has stated that in replacing the term "'more than remote likelihood' with the term 'reasonably possible' within the definition of material weakness and significant deficiency…the PCAOB acknowledges that while this represents a change to the language, no change has been made to the conceptual threshold."

If this is indeed the PCAOB's position, that reasonably possible and probable are theoretically just above the 5-10% range of probability, then there is no need for risk assessment and this should not be considered a top-down or a risk based approach. It would be more appropriately termed a top-down and risk-based **<u>testing</u>** approach. The majority of same, lower relevance controls will continue to remain in scope. The difference will be that the auditors will feel more compelled to alter the nature, timing and extent **<u>of the testing of controls that should not be tested in the first place</u>**. A focus on the risks of material misstatement in the financial statements will remain elusive.

It is recognized that the PCAOB does not desire to define reasonably possible with a quantitative range in the evaluation of control deficiencies (proposed audit standard, section 73). Based on historical interpretation and current commentary from the Big 4 related to this one particular definition, we request much greater clarity in establishing the order of magnitude of what makes the likelihood of material misstatement reasonably possible. Without this clarification, the inevitable result is that it will not be possible to implement a risk assessment strategy, and there will be neither a top-down nor a risk-based approach.

Respectfully,

Todd W. Moore, CPA
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