



February 26, 2007

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

RE: Docket Matter No. 021

To Whom It May Concern:

One of the expressed goals of the Texas Society of Certified Public Accountants (TSCPA) is to speak on behalf of its members when such action is in the best interest of its members and serves the cause of certified public accountants in Texas, as well as the public interest. The TSCPA has established a Professional Standards Committee (PSC) to represent those interests on accounting and auditing matters. The committee has been authorized by the Texas Society of CPAs' Board of Directors to submit comments on matters of interest to the committee membership. The views expressed in this letter have not been approved by the Texas Society of CPAs' Board of Directors or Executive Board and, therefore, should not be construed as representing the views or policy of the Texas Society of CPAs.

We appreciate the opportunity to provide input into your deliberations on Docket Matter No. 021.

Our letter provides comments on each of the questions included in the Exposure Draft of this proposed Auditing Standard.

**1. Does the proposed standard clearly describe how to use a top-down approach to auditing internal control?**

We believe the proposed standard does a good job in describing the top-down approach to auditing internal control. Emphasizing that the auditor starts with the financial statement level and company-level controls and works down to controls over significant accounts and significant processes is most appropriate. We feel that this approach will help the auditor in the planning process and allow him or her to allocate scarce audit resources to those areas most likely to cause concerns about the risk of material misstatements due to errors or fraud.

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

We believe appropriate emphasis is placed on the importance of identifying and testing controls designed to prevent or detect fraud. The listing of several company-level controls and items that the auditor should assess in evaluating the control environment should prove quite helpful. One concern we have is that an auditor might interpret the listed items as an all-inclusive list. To avoid such an interpretation, we believe the proposed standard should state that the list of controls and areas of concern do not constitute an all-inclusive list. Further, the auditor should be reminded to exercise professional judgment in addressing risk factors that might be unique to a particular client. The PSC also believes that specific emphasis should be added to the proposed standard

encouraging the auditor to assess the audit entity's "tone at the top." The tone at the top tends to have a substantial impact on the behavior of entity personnel and serves as an important component in the prevention and/or detection of fraud.

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

We believe this approach represents an improvement over the previous guidance. The top-down approach allows the auditor to focus on those controls that are most significant in the prevention of material misstatements. This approach should serve to make the audit process more efficient since the auditor is required to opine on both the entity's financial statements and the effectiveness of its internal controls.

**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?**

We believe the standard adequately articulates the appropriate consideration of company-level controls and their effect on the auditor's work. The standard does a good job of addressing which controls should be tested by the auditor. The only concern we have is that the proposed standard is written as if all the components will be addressed in every situation. Since there will always be clients or unique situations that the standard cannot predict, auditors should be reminded that when the guidance in the standard does not address a particular situation, reliance should be placed on the auditor's professional judgment.

**5. Does the proposed standard appropriately incorporate risk assessment, including the description of the relationship between the level of risk and the necessary evidence?**

We believe the proposed standard incorporates risk assessment with the auditor's tests of internal controls, as well as the impact that such assessment has on the evidence to be gathered. Again, we feel the standard should make it clear that the discussion of the nature, timing, and extent is meant to be illustrative and is not intended to address evidence-gathering issues and unique situations that may arise during an audit engagement. The proposed standard would benefit from specific illustrations of the relationship between the level of risk and the necessary evidence.

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

We believe a walkthrough should be sufficient to test the design and operating effectiveness of some of the lower risk controls. However, the auditor should be reminded to exercise professional judgment in determining whether such walkthroughs would be sufficient. The sufficiency of a walkthrough should depend on the overall audit risk and how risky the process being assessed happens to be. If a process is considered to be a low-risk process, then a walkthrough should be sufficient in most situations. The standard should emphasize that walkthroughs are highly dependent on the risk profile of the audit client and the nature of the process being considered.

**7. Is the proposed definition of “significant” sufficiently descriptive to be applied in practice?**

The new definition states that “(a) **significant misstatement** is a misstatement that is less than material yet important enough to merit attention by those responsible for oversight of the company’s financial reporting.” In our opinion, this definition provides better guidance than “more than inconsequential” as found in the existing standard. However, we believe reasonable professionals will likely have disparate views of what is “important enough.” This is due to the confusion that we believe exists with the terms “reasonable possibility” and “less than material.” There needs to be further clarification of these terms.

**Does it appropriately describe the kinds of potential misstatements that should lead the auditor to conclude that a control deficiency is a significant deficiency?**

We do not believe the definition appropriately describes the kinds of potential misstatements that should lead the auditor to conclude that a control deficiency is a significant deficiency. We were unable to find the description referred to in this question within paragraphs 70 – 79 of the proposed standard which deals with this new definition. Thus, if the guidance does exist, it appears to be misplaced.

**8. Are auditors appropriately identifying material weaknesses in the absence of an actual material misstatement, whether identified by management or the auditor?**

We believe it is extremely difficult to assess the potential impact of a control weakness if it is only potential. The fact that the control weakness has never had any material impact argues against its potential materiality, but other evidence could indicate a high probability that it is material. We believe in most instances, such an issue would result in considerable discussions involving the auditor, management, and the audit committee. A final conclusion regarding such issues involves the exercise of professional judgment, and the aforementioned parties are the correct group to be exercising that judgment.

**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?**

We believe the proposed standard should include a definitive statement to the effect that the failure to identify a material misstatement does not negate the auditor’s responsibility to identify any existing material weaknesses.

**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?**

We believe the proposed changes should reduce the effort. In our opinion, the existing guidance was already clear regarding the intent of the standard. The revisions in the proposed standard should help to make the language of the standard agree with the guidance.

**10. Should the standard allow an auditor to conclude that no deficiency exists when one of the strong indicators is present?**

Since the overall assessment is a matter of professional judgment, such decisions should be left to the auditor.

**Will this change improve practice by allowing the use of greater judgment?**

We believe the change will improve practice. Leaving the auditor free to exercise his or her professional judgment is the best approach. Trying to micromanage the audit is an inappropriate course of action.

**Will this change lead to inconsistency in the evaluation of deficiencies?**

There is always the potential that the exercise of professional judgment will vary somewhat among audit professionals. However, we believe that given the larger framework and other available guidance, the differences will be at the margins where significant judgment is required, not in the majority of situations. We believe there will be far less inconsistency in the evaluation of deficiencies.

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

We believe the proposed standard makes it clear that the goal is to avoid detail tests of every control and that the focus should be on those areas that have the highest risk and are most likely to lead to material misstatements. However, there needs to be enhanced guidance on the scope of the audit of internal control where entities with multiple locations are involved. We still lack the necessary guidance in this area, especially as it regards an integrated 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 believe the reference to interim should remain, but this entire area is in need of clarification due to the confusion that exists in practice. It is still important to evaluate whether the controls are effective throughout the year and not just at year end. The sections of the proposed standard that discuss audit scope and evaluation are sufficient to overcome any tendency to set audit scope too low. However, it should be pointed out that materiality is not the same for interim and annual financial statements, and appropriate adjustments should be made when interim vs. annual financial statements are being considered.

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

We do not believe there will be any reduction in audit work as a result of removing the requirement for an evaluation of management's process.

**14. Can the auditor perform an effective audit of internal control without performing an evaluation of the quality of management's process?**

Whether you call it an "assessment" or an "understanding," we believe the auditor needs to know what management has done in order to determine the nature, timing, and extent of his or her audit engagement tests.

**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?**

In essence, we believe that both opinions are not really needed.

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

The value of cumulative knowledge is appropriately incorporated in the proposed standard.

**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?**

We believe walkthrough procedures would prove reliable in areas where there is little risk of capturing and properly recording, as well as in processes with low materiality to the financial statements. The auditor should only be testing key controls for relevant assertions in significant accounts which by definition mean they are material and have a high risk of material misstatement. Therefore, relying on only a walkthrough in such areas would seldom, if ever, produce sufficient evidence.

**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 question whether the proposed standard's approach for determining the scope of testing in a multi-location engagement will result in more efficient multi-location audits. We believe this proposed standard is much too vague in providing adequate guidance for an integrated audit. The auditing literature lacks adequate guidance in this area in general, and this proposed standard does not appear to correct this guidance deficiency. This answer tends to reiterate the concern we expressed earlier in our response to Question 11. Until greater guidance is provided on scope determination in multi-location engagements, practitioners will continue to be inefficient in the audits of multi-location entities.

- 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?**

We believe a single framework for using the work of others for both an integrated audit and an audit of only financial statements is appropriate. An integrated audit and an audit of only financial statements both rely on the general standards of GAAS and the same standards for the gathering of audit evidence. This is true whether testing controls for the purpose of an audit of internal control or testing controls, account balances, and disclosures for an audit of the financial statements. The key factors used by the auditor in determining reliance are the same – the nature of the subject matter tested and the competence and objectivity of the persons performing the tests. Thus, we do not believe different frameworks are necessary.

- 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?**

We believe the proposed definition adequately captures the correct scope of activities. Relevant activities encompass two types of tests: (1) tests of the design and operating effectiveness of internal controls over financial reporting; or (2) tests that provide evidence about potential misstatements of the financial statements.

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

We do believe that such an understanding has the potential to provide benefit to the auditor in improving audit quality. While the proposed standard does not change the requirements that an auditor must meet, the use of work performed by others may provide the auditor with additional insight due to specialized knowledge and expertise possessed by the other individuals. The auditor can always benefit from information developed by those individuals performing relevant activities.

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

We do not believe the principal evidence provision found in AS No. 2 was necessary. If the auditor can obtain sufficient appropriate evidence through the work of others, the principal evidence provision of AS No. 2 only increases the direct work required by the auditor with no enhancement of the quality of the results achieved. If auditors are expected to exercise professional judgment, the standards should support this expectation.

- 23. Does the proposed standard provide an appropriate framework for evaluating the competence and objectivity of the persons performing the testing?**

We agree the auditor should consider traits such as the education, professional experience, certification, supervision, and work product quality in evaluating an individual's competence. Traits such as independence from the area under review, the organizational placement of those responsible for the work of others, and policies concerning compensation arrangements should be considered when assessing an individual's objectivity. We do suggest the development of specific guidance on testing the competence, objectivity, and work product of the persons performing the testing.

**Will this framework be sufficient to protect against inappropriate use of the work of others?**

We believe the standards are objective and measurable, and the framework is appropriate. Facts and circumstances supported by professional judgment should always dictate the extent of reliance that can be placed on the work of others.

**Will it be too restrictive?**

We do not believe it will be too restrictive. These factors are no different than those auditors apply to their own personnel in gauging competence, objectivity, and quality of work.

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

We find the criteria provided in the proposed standard to be objective, measurable, and sufficient for its intended purposes.

**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 this eliminates the potential of an individual's compensation being tied to achieving a particular result, either positive or negative, in the final outcome of the testing. It also seems to eliminate the potential challenge to the result of the testing based on a factor which could indicate a vested interest in achieving a particular result. Compensation is always a factor, but not necessarily a major factor. Of greater importance is how independent the person is, to whom he or she reports in the organization, and his or her professional qualifications.

**26. Will requiring a walkthrough only for all significant processes reduce the number and detail of the walkthroughs performed without impairing audit quality?**

We believe the split between significant process and major classes within each significant process is more form than substance. In the example presented in the proposed standard, why wouldn't an auditor do a walkthrough of Internet sales? It is obviously a different process than retail sales with different controls and risks. How would one know if he or she didn't gain an understanding of both processes? In most circumstances, how would it be possible to gain an understanding without performing a walkthrough?

**27. Is it appropriate for the auditor to use others as direct assistance in performing walkthroughs?**

We believe the answer to this question rests on the significance of the transaction cycle. We feel the auditor generates a greater degree of comfort if he or she does the walkthrough when a significant transaction cycle with high risk implications is involved. The understanding obtained in such circumstances is too important to delegate to other individuals. As always, the significance of the transaction cycle is a matter of professional judgment to be exercised by the auditor.

**Should the proposed standard allow the auditor to more broadly use the work of others in performing walkthroughs?**

We do not support allowing the auditor to more broadly use the work of others in performing walkthroughs. As noted in the first part of this question, we find that the critical nature of the process to the audit should be the controlling factor in determining who performs the walkthrough. To allow for a broad consideration of who should perform the walkthrough would lead to an inconsistent and inappropriate approach to the walkthrough process on the part of auditors. This understanding is too important to relegate to a broad and flexible set of guidelines.

**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?**

While the proposed standard presents a strong theoretical description of the issue of scaling the audit for the size and complexity of the company, it does not provide much practical guidance. We believe the proposed standard tends to lack useful guidance in this area and is deficient in helping audit practitioners make informed judgments that will result in efficient and effective audits. Practitioners need practical guidance upon which to base the exercise of professional judgment. To merely include a dialogue that does not lend itself to practical application results in confusion and a variety of approaches that do not meet the intent of the standard.

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

We believe the proposed standard was adequate in this area.

**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?**

We have no additional suggestions in this area.

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

We don't believe it does.



- 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 believe they are meaningful to size, but not necessarily to complexity. It is important to note that a diversified or decentralized large company can have business locations or business segments that are managed and controlled more like a small business.

- 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?**

We are not aware of any other information.

- 34. How can the Board structure the effective date so as to best minimize disruption to the 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?**

We believe that since this is an audit standard, public accounting firms need at least one year to modify their internal processes and change their firm-wide methodology to comply with the proposed standard. If approved by the SEC in mid-2007, it should be effective for the audits of companies with years ending after December 15, 2008. We do believe earlier application should be encouraged.

We appreciate the opportunity to provide input into the standard setting process.

Sincerely,



Sandra K. Johnigan, CPA, CFE  
Chair, Professional Standards Committee  
Texas Society of Certified Public Accountants