



THE OHIO SOCIETY

OF CERTIFIED

PUBLIC

ACCOUNTANTS

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

The Auditing Standards Task Force of The Ohio Society of CPAs reviewed the proposed auditing standard, "An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements and Related Other Proposals," and submits the following comments for your consideration.

Overall Comments:

The task force supports the movement of the standard to a more risk-based approach to audits of internal control over financial reporting. In particular, provisions of this standard that will be of benefit include removing some limitations to relying upon the work of others, and allowing greater use of professional judgment, which will drive greater efficiencies. Becoming more principles-based introduces greater flexibility, which all parties want, but at the cost of the introduction of greater variation in practice and potentially greater risk. It's important to point out that clarification of the auditor's responsibilities via the standard is only part of the solution. For these changes to result in efficiencies in practice, Board inspections need to closely align with the use of professional judgment in applying a risk-based approach that the standard intends. For example, as auditors are exercising greater professional judgment, inspections performed by the PCAOB need to support judgments that were made, so long as they are in line with the intent of the standards and have a reasonable basis for support.

Throughout the standard, task force members commented on the inclusion of concepts of "efficiency," for example, referring to an auditor "only" doing something (for example, paragraphs 3, 8, and 16 in the proposed standard). This concept would be precedent setting in an auditing standard, and we believe is inappropriate. Building efficiency considerations into the standard is understandable in the context of minimizing excess procedures and scaling to less complex entities. However, while efficiency considerations may have a place in implementation guidance related to the standard, they should not be part of the standard itself. It is more appropriate for an auditing standard to address procedures in terms of consistency or quality.

Members also questioned whether this standard supersedes any previously existing implementation guidance. In particular, as referenced throughout the comments, much of the May 16, 2005 guidance was considered to still be

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applicable in the context of this proposed standard, and in many sections, it is recommended that certain sections of the guidance be incorporated.

We appreciate the opportunity extended by the PCAOB for our review and comments in response to the proposed auditing standard. Should the PCAOB wish to further discuss any or all our feedback, we would be pleased to do so.

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

Directing the Auditors' Attention Towards the Most Important Controls:

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

The proposed standard is consistent with the May 16, 2005 guidance, and therefore may not lead to significant changes in practice. It clarifies the need to focus on key controls. Consider incorporating language from Q&A #38 in the May 2005 guidance, which offers a more detailed and specific explanation of a top-down approach.

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

The proposal clarifies the need to assess controls on the basis of risk of material misstatement. The proposal is not as clear on the need to establish controls specifically focusing on the prevention and detection of fraud. If that is the intent of the draft, the proposal should clarify the focus on fraud controls. In PCAOB Auditing Standard No. 2, paragraph 24 on fraud considerations provided some guidance in this area.

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

Yes, although the May 16, 2005 guidance has already helped auditors with this focus.

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?*

The proposal is clear on the expectation to gain an understanding of company-level controls in achieving an understanding of the control environment, but is not sufficiently clear on how the auditor takes company-level controls into consideration in assessing the level of testing

of other controls. In many cases, company-level controls have an indirect influence on specific controls. We questioned whether there is any instance where a company-level control would prevent or reduce testing a lower-level key control, and concluded such circumstances would be very limited. Additional clarification is necessary on circumstances under which company-level controls could reduce the scope of testing, especially of a lower-level key control, and how the auditor takes those controls into consideration in reducing or eliminating testing.

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 suggest the risk assessment guidance provided in the May 16, 2005 guidance be incorporated in the auditing standard. With this proposal and the SEC proposed interpretive guidance, we envision greater divergence between the external auditor and management in assessing what risks are significant. While the potential for differing assessments is not necessarily a negative consequence, the draft should provide additional guidance on how the auditor and management reach consensus on key controls (in the absence of such guidance, the auditor assessment will prevail.)

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

It is possible in a situation with strong company-level controls and testing in prior audits, cumulative knowledge and experience could permit conducting a walkthrough in subsequent audits for a lower risk control. Examples of such circumstances in the standard would be beneficial (and those circumstances should be limited.) A walkthrough should never be sufficient for first-time testing of a key control, and conclusions regarding the effectiveness of the related control should be revalidated periodically by testing beyond a walkthrough.

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?*
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?

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?*

(7,8, and 9) We don't believe the new definitions improve the ability of an auditor to preemptively or more consistently identify potential material misstatements. The degree of subjectivity in the definitions continues to provide for a high degree of judgment and interpretation, and greater subjectivity will not likely reduce the aggressiveness of application.

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?*

Yes.

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

The change clarifies the role of judgment that was already permitted in AS2, but will not likely change current practice.

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

Additional guidance would be beneficial. Many firms and issuers have found the guidance on the evaluation of deficiencies in the paper "Framework for Evaluating Control Exceptions and Deficiencies" prepared by the largest CPA firms useful in providing common ground for management and auditors in this respect.

Clarifying the Role of Interim Materiality in the Audit:

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

As noted in response to question 5, management may make a differing assessment of significant locations, processes and controls from external auditors. However, a common occurrence will be that management will perform testing of key controls as identified by the external auditors to reduce overall costs (provides auditors with an opportunity to use their

work). There needs to be a process for management and auditors to reach consensus regarding significant locations, processes and controls.

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?*

References to interim financial statements should be removed from the definitions. Due to the cyclical nature of controls testing activity, it is difficult to pinpoint the effect of the deficiency on the interim financial statements, unless the deficiency resulted in an audit adjustment or the need for a restatement. Removal will not affect the scoping of the audit, as the audit is scoped to conclude on internal control as of the balance sheet date. Eliminating the requirement to evaluate the significance of all control deficiencies against interim materiality would be consistent with the objective of reducing unnecessary work.

B. Eliminating Unnecessary Procedures

Removing the Requirement to Evaluate Management's Process:

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

The opinion required on management's assessment process provides little value and adds confusion to the marketplace, therefore it should be eliminated.

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

The evaluation of the quality of management's assessment process is a critical part of gaining an understanding of the organization that is used as a basis for scoping the engagement.

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?*

Yes. Some parties have been confused by the two opinions, and this change will clarify the subject of the auditor's opinion.

Permitting Consideration of Knowledge Obtained During Previous Audits:

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

It would be helpful to have examples of how cumulative knowledge can be reflected in adjusting the scope of testing.

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?*

See response to question 6.

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?*

Yes, consistent with the shift in emphasis to risk-based assessments, and consistent with the May 16, 2005 guidance. This increase in effectiveness will likely be offset by greater variability in practice due to the increased emphasis on auditor judgment.

Removing 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?*

Two separate frameworks would be confusing and may be misleading. Both the work of the external auditor and that of management point to the reliability of the financial statements. A single framework is preferred, emphasizing the consideration of competence and objectivity. Consider an update of SAS 65 as a potential solution (versus issuing a separate auditing standard).

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?*

Yes; however, the identification of relevant activities should be performed in conjunction with the evaluation of competence and objectivity. In other words, auditors should only consider relevant activities where there is an opportunity to rely upon them.

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

Yes, although these matters are often shared between management and auditors today.

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

While the provision may have been necessary for initial implementations, it is no longer necessary. Professionals are able to determine when they have gathered sufficient evidence to support their opinion.

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 proposed framework is appropriate.

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

The factors identified are adequate.

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?*

This factor could be perceived as intrusive, to the point where qualified individuals will opt out of this role. This factor should be included as one of the considerations in evaluating competence and objectivity, but does not deserve special prominence.

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?*

No. This clarifies what for many is current practice.

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?

Yes, but as outlined in question 6, only for certain mutually agreed-upon low risk processes. Higher risk areas should have an external auditor walkthrough, based upon the auditor's discretion.

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?*

The proposed standard provides guidance on how to apply the fundamental concepts already existing in AS2 to a control environment in which, for example, an entity cannot maintain as well-defined segregation of duties or as many detailed controls. It's important to clarify whether publication of this standard supersedes already existing guidance, or how it may be applied for such entities. For example question #53 in the Q&A guidance would be relevant to this section.

The discussion of evidence would benefit from additional clarification of how the auditor should compensate for reduced evidence. Even if a purpose of the standard is to require less evidence in a small company environment, it would be helpful to establish some acceptable level of documentation – what are the minimum elements that need to be present?

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

None were noted.

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?*

No.

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

The standard is reasonably clear on the complexity factor.

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?*

Unless market capitalization and revenue thresholds are to be used to exempt certain levels of companies from the requirements of the standard, these are not meaningful measures. More appropriate would be measures of complexity, such as number of processes, locations or layers of management.

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?*

Auditors' interaction with audit committees improved with the introduction of AS2, including required content and frequency. Nothing should be changed at this time.

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?*

Assuming a final standard can be available in the second quarter, the optimal effective date would be for calendar year-end 2007 audits. Should the standard be issued later than the second quarter, consider an effective date for years ending June 30, 2008 or thereafter, with early adoption encouraged.

If you have any questions about the above comments or deliberations of the task force, please contact me at the following telephone number or e-mail address.

Sincerely,

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