The Institute of Internal Auditors

David A. Richards
Certified Internal Auditor
President

July 12, 2007

Ms. Nancy M. Morris
Secretary, U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Response e-mailed to: rule-comments@sec.gov

Re: SEC Release No. 34-55912; File No. PCAOB-2007-02
ADDITIONAL SOLICITATION OF COMMENTS ON THE FILING OF PROPOSED RULE ON AUDITING STANDARD NO. 5

Dear Ms. Morris:

The Institute of Internal Auditors (The IIA) welcomes the opportunity to comment on the referenced release. Our comments are based on in-depth analysis and discussions, harnessing the experience of a core team of prominent chief audit executives from major U.S. corporations who serve on The Institute of Internal Auditors' Professional Issues Committee.

Our response to each of the questions contained in the release is noted below.

(1) Is the standard of materiality appropriately defined throughout AS5 to provide sufficient guidance to auditors? For example, is materiality appropriately incorporated into the guidance regarding the matters to be considered in planning an audit and the identification of significant accounts?

The standard is clear in its intent, guiding the auditor only to include in scope for both parts of the integrated audit, only areas where there is at least a reasonable risk of a material error in the financial statements. However, we believe that some auditors need further and clearer guidance than is provided. We understand that one major audit firm continues to allocate materiality and additionally apply a tolerable error factor, resulting in scope that is designed to identify errors at a significantly lower level than that envisaged by the standard.

We recommend that clarification and emphasis be given, directing the auditor to apply the same materiality level (the risk of a material error) for both the financial statement audit and the internal control over financial reporting (ICFR) part of the integrated audit. The practice of allocating materiality should be identified as inconsistent with the standard.

Global Headquarters
247 Maitland Avenue
Altamonte Springs, FL
32701-4201 U.S.A.
Tel: +1-407-937-1100
Fax: +1-407-937-1101
www.theiia.org

Tel: +1-407-937-1200 • Fax: +1 407-937-1101 • E-mail: dave.richards@theiia.org

(2) Please comment on the requirement in Paragraph 80 that the auditor consider whether there are any deficiencies or combinations of deficiencies that are significant deficiencies and, if so, communicate those to the audit committee. Specifically, will the communication requirement regarding significant deficiencies divert auditors' attention away from material weaknesses?

The new definition of a significant deficiency is consistent with the recommendation to the SEC in our comments on the proposed guidance, and we give it our full support. We believe it will add efficiency by emphasizing the use of judgment and removing unnecessary debates with company management as to whether the issue meets the definition. Emphasizing that the scope of audit work must be limited to areas where there is at least a reasonable likelihood of a material error will keep the auditors focused.

(3) Is AS5 sufficiently clear that for purposes of evaluating identified deficiencies, multiple control deficiencies should only be looked at in combination if they are related to one another?

We agree that multiple control deficiencies should be aggregated for assessment purposes when there is at least a reasonable likelihood that they will result in errors in the financial statement during the same period. However, the guidance may not be as clear as it should be in the new standard (for example, the test described in this question of "related to one another" is insufficient). For multiple control deficiencies to be aggregated, the underlying root causes should be correlated (e.g., as a result of a failure of the same key report) so that concurrent failures are likely; this should be clarified in the guidance.

(4) Please comment on whether the definition of "material weakness" in Paragraph A7 (which is consistent with the definition that the SEC adopted) appropriately describes the deficiencies that should prevent the auditor from finding that ICFR is effective.

We believe the definition lacks a necessary ingredient. It is not possible to assess whether there is a "reasonable possibility" without specifying the time period. We have recommended that the quality of internal control over financial reporting should be forward-looking, considering the likelihood of an undetected error in financial statements filed with the SEC in the next year.

(5) Is AS5 sufficiently clear about the extent to which auditors can use the work of others?

Paragraphs 16-19 of the standard leave the matter to the judgment of the auditor. The extent to which that judgment is appropriately exercised will only be seen over time.

This is an area of specific interest to The IIA. We believe factors to be considered when assessing competency and objectivity should include:

- Whether the individual's activities are governed by a Code of Ethics, such as that of The IIA.
- Whether the individual or the department adheres to recognized standards that address quality and objectivity, such as *The International Standards for the Professional Practice of Internal Audit*.
- Whether the certifications held by the individual are relevant to the work performed.

We also suggest that the objectivity of individuals who test matters in areas in which they work, even if they are not in supervisory positions, may be impaired.

Additional benefits can be achieved by guiding the auditor to consider the potential use of the work of others during the planning process. Discussions with appropriate parties should be held early to ensure that the work will be performed to quality standards and agree on the scope of work to be performed.

Including in the standard comments about the auditor's responsibility to perform an efficient audit would be valuable. Relative to the use of the work of others, the guidance might stress the need for early planning and definition of the scope of work, and the possibility of increased reliance on the work of others.

(6) Will AS5 reduce expected audit costs under Section 404, particularly for smaller public companies, to result in cost-effective, integrated audits?

We expect the top-down and risk-based approach will result in more cost-effective audits.

(7) Does AS5 inappropriately discourage or restrict auditors from scaling audits, particularly for smaller public companies?

The focus in AS5 on the risk of a material misstatement is appropriate and should be applied to companies of all sizes. The short guidance in paragraph 13 neither encourages nor discourages scaling audits.

Again, The IIA would like to offer its support to the SEC in the development of their guidance. We have an extensive volunteer network of individuals with specific knowledge in this area that could be valuable contributors to the SEC.

The IIA welcomes the opportunity to discuss any and all of these recommendations with you.

Best regards,

David A Richards

David A. Richards, CIA, CPA

About The Institute of Internal Auditors

The IIA is the global voice, acknowledged leader, principal educator and recognized authority of the internal audit profession and maintains the *International Standards for the Professional Practice of Internal Auditing (Standards)*. These principles-based standards are recognized globally and are available in 25 languages. The IIA represents more than 130,000 members across the globe, and has 247 affiliates in 92 countries that serve members at the local level.