Via e-mail: comments@pcaobus.org

October 27, 2003

Public Company Accounting Oversight Board
Office of the Secretary
1666 K Street, NW
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 008;
Proposed Auditing Standard – An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

Dear Secretary:

Dixon Odom PLLC (Dixon Odom) appreciates the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB) proposed auditing standard relating to audits of internal control over financial reporting (the Proposed Standard). Dixon Odom is the largest CPA firm based in the Southeast with 450 employees and 16 offices in 6 states, auditing approximately 40 public companies.

Dixon Odom supports the issuance a new standard on auditing internal control over financial reporting that will meet the objectives of section 404 of the Sarbanes-Oxley Act of 2002. Regarding the Proposed Standard, we have the following comments.

Selected Questions
(numbers refer to question numbers in the Proposed Standard)

- 1. No. We would prefer that the term "audit" be used only to refer to an audit of financial statements to differentiate that level of service from other types of services. As indicated in the Proposed Standard, an audit of internal control over financial reporting is very different from an audit of the financial statements.
- 2. Yes. We believe these two engagements should be performed by the same auditor.
- 4. No. We would like to see additional information in this area. See "other comments" section below.
- 5. No. This would be unworkable and would create inconsistencies with financial statement audit requirements.
- 8. Yes. Documentation, especially at small entities, will vary greatly company to company. Inadequate documentation should not automatically result in a certain type of opinion.

- 10. No. If auditors can rely on work done by internal audit, management, and others in a financial statement audit and other aspects of an audit of internal control over financial reporting, it does not seem appropriate to require auditors to perform the walkthroughs themselves. It would be appropriate to require some level of subtesting of any work done by others in this area.
- 15. Yes. In order to rely on the work of others, auditors will have to perform some tests of their work. However, further mandating specific tests is not necessary, especially in connection with the overall requirement that the principal work be that of the auditor.
- 16. Yes.
- 17. See “other comments” below relating to these definitions.
- 22. No. See “other comments” below.
- 23. No. See “other comments” below.
- 24. No. Audit committee effectiveness is a very subjective area, and any guidance or requirements issued in this area should be broad rather than specific.
- 26. Yes. Many small entities could have appropriate controls, but there also could be segregation of duties issues that would best be addressed by an except for opinion.
- 28. Yes. The SEC recently issued an FAQ on auditor independence in addition to its recent rules on the topic. However, the rules and FAQ do not provide enough guidance in this area. Any additional guidance from the PCAOB would be helpful.

Other comments

- Although the term “internal control over financial reporting” is defined in the Proposed Standard, the term “control” is not. A definition or specific examples of controls would be useful. More specifically, it would be helpful to differentiate a control from a process. For example, the CFO may prepare a schedule calculating the valuation allowance for receivables. The preparation itself seems to be a process, not a control, as mere preparation by one individual would not prevent or detect a misstatement if errors were made. As another example, paragraph 41 includes as a control “controls over the selection and application of accounting policies that are in conformity with generally accepted accounting principles.” Selecting and applying accounting policies also appears to be a process and not a control.

- Section 302 of the Sarbanes-Oxley Act of 2002 requires management to certify as to disclosure controls and procedures as well as internal control over financial reporting. The Section 302 certification, for example, addresses not only disclosures in the financial statements, but also disclosures in the quarterly or annual report filed with the SEC. Additionally, the FDICIA management reports (and related auditor attestation reports) filed by large banks may address financial reporting in accordance with generally accepted accounting principles and the Federal Financial Institutions Examination Council instructions for Consolidated Reports of Condition and Income (call report instructions). We therefore recommend that the Proposed Standard be revised to clearly specify that the engagement to audit internal control over financial reporting only applies as it relates to the audited financial statements and footnotes thereto, and not to other external financial reporting.

- The Proposed Standard introduces a new concept in discussing significant deficiencies in internal controls: a concept that a misstatement may be “more than inconsequential”. Presumptively, this definition of “more than inconsequential” would still be less than “material” since material misstatements would result in a material weakness in internal controls versus a significant deficiency. Currently, as auditors we must determine whether or not the financial statements are presented fairly in all material respects. Items that are material to the financial statements have been properly recorded, and any potential uncorrected misstatements are immaterial. The Proposed Standard now adds a third possibility that a misstatement could be less than material (i.e., immaterial) yet would still be highlighted because it is more than inconsequential. We believe the introduction of this new concept will only add to confusion regarding the relationship between the audit of the financial statements and the audit of internal control over financial reporting. We therefore recommend eliminating the concept of “more than inconsequential”.

- Management’s assertion as to internal control over financial reporting is to be made as of the end of year. This is analogous to an audit of the balance sheet, which is as of a point in time, versus a statement of operations, which covers a period of time. The Proposed Standard, however, introduces the concept in paragraphs 99 and 166 that if management changes controls during the year, there should be a sufficient time period that passes in order to determine that the new controls have been operating effectively. Otherwise, superseded controls would need to be evaluated. Given that management’s assertion is as of a point in time, we do not see the relevance of evaluating controls as of a date other than the period specified in management’s report when there has been a change in controls. For example, many acquisitions close at the end of a quarter or fiscal year. The controls resident at the acquired entity would be subject to management’s assertion as of the end of the year. However, controls prior to that point in time do not seem relevant. A similar analogy can be made for a year-end system conversion - the controls in effect prior to the conversion would not be covered by management’s end of year assertion as to effectiveness of controls.

- The Proposed Standard notes that controls must be tested by the auditor in order to evaluate operating effectiveness. Additional guidance as to appropriate sample sizes would be useful. Appendix B, Examples B-1 and B-3 indicate that a daily control is tested using a sample size of 25. Does the PCAOB intend that a sample size of 25 is considered the requirement for testing a daily control?

- Evaluation of the effectiveness of the audit committee is required by the Proposed Standard. For the reasons indicated in the following paragraph, we believe such a requirement is too far reaching and unworkable. In addition, auditors have recently been criticized for being too beholden to management, who prior to changes brought about by the Sarbanes-Oxley Act typically engaged the auditor and determined the auditor's fees. Many viewed this arrangement as containing an inherent conflict of interest. Under the current rules issued by the SEC, audit committees are now responsible for approving the auditors. Requiring auditors to separately evaluate the effectiveness of the audit committee will reintroduce the same conflict of interest scenario that the new SEC rules were meant, in part, to eliminate.

  Paragraph 57 indicates various factors that the auditor should evaluate in assessing audit committee effectiveness. Some of these factors, such as "how well the audit committee and management understand" audit committee responsibilities, are very subjective. As another example, the independence evaluation in paragraph 58 asks "does management pick 'friends'?" Asking auditors to evaluate audit committee members' understanding of responsibilities or whether or not those members are friends of management introduces a great amount of subjectivity to the audit of internal controls. Additionally, the Proposed Standard also requires evaluation of the audit committee's compliance with Section 301 of the Sarbanes-Oxley Act. AT 601, *Compliance Attestation*, of the AICPA's attestation standards currently provides guidance for a separate engagement to evaluate compliance with laws and regulations. Subsuming this sort of compliance evaluation into an audit of internal control over financial reporting conflicts with an already existing standard and overreaches the boundaries of an internal control engagement.

- Paragraph 79 of the Proposed Standard requires auditors to perform walkthroughs of all of a company's significant processes, indicating an auditor "should trace all types of transactions and events". Given that this procedure is a requirement (i.e., "should" perform), further guidance is needed on what the term "all types of transactions and events" means. If this language were to be broadly interpreted, theoretically every nonrecurring transaction in a significant process would need to be traced as each one would be different. Within recurring transactions, there could literally be hundreds of transaction types depending on amounts, counter parties, geography of counter parties, timing, sales channels, etc. Therefore, we recommend the language change to something like “In a walkthrough, the auditor traces a representative sample of transactions …” or “…significant categories of transactions…”

- Paragraph 157 notes that the auditor’s report on internal control over financial reporting should be dated the same as the audit opinion on financial statements. However, financial statements of public companies can be audited without a corresponding audit of internal controls. By indicating that “the reports should be dated the same”, there is an implication that a financial statement audit is not complete until the audit of internal control engagement is complete. If this is the goal of the PCAOB, the Proposed Standard should be revised to address this concept in more detail. Additionally, revisions to AICPA auditing standards adopted by the PCAOB as of April 16, 2003 may be needed. Otherwise, this language should be revised to indicate that the audit report on internal controls should be dated no earlier than the date of the audit report on the financial statements.

- The illustrative reports in Appendix A reference in the definition paragraph “generally accepted accounting principles”. The audit report on financial statements, as illustrated in Example A-6, reference in the opinion paragraph “accounting principles generally accepted in the United States of America.” We recommend conforming the language in the definition paragraph of the audit report on internal controls to the language used in the audit report on financial statements.

- Appendix E provides summary guidance for small and medium-sized companies. Dixon Odom’s public company audit practice consists entirely of such companies. The Proposed Standard recognizes in paragraph E9 that the CFO’s review of ratios and day-to-day involvement go “a long way in identifying and preventing material errors in the financial statements.” We agree with the point of the statement, but the CFO’s day-to-day involvement may not necessarily include “controls”, depending on how that word is defined (see our first comment). Procedures and controls in a smaller entity are less formal, and documentation may be very limited. Therefore, we would like to see more guidance on documentation expectations for small entities as well as more guidance on testing controls that may not be documented.

  Additionally, CFO’s in smaller entities typically rely heavily on their external auditor to ensure that the accounting principles used are appropriate and that proper disclosures are made. Reliance on the external auditor to provide substantial guidance in this area may not be a control per se, but it is reality. Audit committees of small entities rely similarly on outside auditors for advice on best practices for smaller entities. CFOs and audit committees of small entities depend heavily on external auditors and other professional advisors for expertise in many areas, including GAAP and SEC rules and regulations, since the resources of these companies are limited. Small entities take great comfort in the fact that their external accounting firm is reviewing and providing significant feedback on the financial statements and related disclosures, giving guidance over selection and application of accounting principles, and helping audit committees evaluate their role and the applicability of the myriad of regulations resulting from the Sarbanes-Oxley Act to small entities. For those reasons, we would like to see the Proposed Standard specifically address selection of accounting principles, preparation of financial statements and related note disclosures, and evaluating audit committee effectiveness for smaller entities, including the role of the accounting firm in these areas.

- As part of a financial statement audit under current GAAS, auditors may issue reports relating to internal controls such as a management letter, reportable conditions letter, or a no material weaknesses letter. These letters typically speak to the fact that the financial statement audit does not provide assurance on internal control. In connection with the issuance of the Proposed Standard, we would like to see the PCAOB provide guidance on the form and content of the aforementioned internal control letters (or audit byproduct letters), including whether or not they will be superseded by the Proposed Standard.

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Again, we appreciate the opportunity to comment on the Proposed Standard. Thank you for considering our views. We would be glad to discuss our views with you in further detail.

Respectfully submitted,

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