To: Public Company Accounting Oversight Board

From: Larry J. Scott, CPA
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Subject: Response to Proposed Standards for the Audit of Internal Controls
Docket Matter No. 008

Date: November 19, 2003

Please find attached my responses to the 31 questions outlined in the proposed internal control auditing standards.

I applaud the efforts of the Board in establishing new standards. I appreciate your efforts to be fair and reasonable regarding implementation of the new standards and the opportunity to respond to the proposals. I would also encourage the Board, as I am certain you will, to take due care in finalizing the new requirements by considering all respondents concerns, including the costs (both external and internal) to implementing the new rules.

In conversations with many colleagues, as well as those in public accounting, I get the impression of grave concern that the new requirements will significantly increase external audit fees as well as use valuable internal resources to implement the new standards. The rules were established to restore investor confidence in financial reporting and hence require the involvement of management and the public accountants in the audit process, with which I firmly agree. The Board, however, must be diligent in its oversight (both of the auditor and of management) to ensure that the new standards (however good intentioned) are focused on the objective and not merely a method to restore fees to the public accounting industry.

I am the Vice President, Audit of a mid-size listed company. The opinions expressed in this response are mine and may not necessarily reflect the opinions of my employer.

Sincerely,

Larry J. Scott, CPA

PROPOSED AUDITING STANDARD –
AN AUDIT OF INTERNAL CONTROL OVER
FINANCIAL REPORTING PERFORMED IN
CONJUNCTION WITH AN AUDIT OF FINANCIAL
STATEMENTS
PCAOB Release No. 2003-017
October 7, 2003
PCAOB Rulemaking
Docket Matter No. 008

1. Is it appropriate to refer to the auditor's attestation of management's? Assessment of the effectiveness of internal control over financial reporting as the audit of internal control over financial reporting?

Yes. Not only is it appropriate, some investors have likely been under the impression that the external audit of financial statements was also an evaluation of a company's internal controls.

2. Should the auditor be prohibited from performing an audit of internal control over financial reporting without also performing an audit of the financial statements?

No. However, an audit of the financial statements should require the same external auditor to express an opinion of the financial reporting controls.

3. Rather than requiring the auditor to also complete an audit of the financial statements, would an appropriate alternative be to require the auditor to perform work with regard to the financial statements *comparable to* that required to complete the financial statement audit?

Yes, but if PCAOB truly believes that this process is an integrated audit then there should only be a single audit resulting in a single opinion.

4. Does the Board's proposed standard give appropriate consideration to how internal control is implemented in, and how the audit of internal control over financial reporting should be conducted at, small and medium-sized issuers?

No. Not only does the proposal not address smaller public companies, it does not adequately address the concerns of larger companies.

5. Should the Board, generally or in this proposed standard, specify the level of competence and training of the audit personnel that is necessary to perform specified auditing procedures effectively? For example, it would be inappropriate for a new, inexperienced auditor to have primary responsibility for conducting interviews of a company's senior management about possible fraud.

No. While clearly a junior person should not interview a senior executive for several reasons, the level of competence is a function of cost and quality. This would be best left to company's representatives and the public accountants to negotiate staffing and an appropriate fee structure based on quality of work, hours required, and issues identified during the audit.

6. Is the scope of the audit appropriate in that it requires the auditor to both evaluate management's assessment and obtain, directly, evidence about whether internal control over financial reporting is effective?

No, the scope content is too broad. Public companies will be at the mercy of public accountants that will no doubt interpret the rules to mean more work rather than less.

7. Is it appropriate that the Board has provided criteria that auditors should use to evaluate the adequacy of management's documentation?

Yes, but as discussed above, the criteria must be very specific.

8. Is it appropriate to state that inadequate documentation is an internal control deficiency, the severity of which the auditor should evaluate? Or should inadequate documentation automatically rise to the level of significant deficiency or material weakness in internal control?

Inadequate documentation of a "significant process" or a "material location or business unit" should be evaluated by the public accountant along with the company's management, but may not necessarily be a material weakness. Inadequate documentation should not automatically escalate to a significant deficiency absent an examination of materiality

9. Are the objectives to be achieved by performing walkthroughs sufficient to require the performance of walkthroughs?

Yes, for routine transactions. However, for non-routine transactions a walkthrough would not be helpful. In fact, most non-routine transactions of a material or significant amount are the subject of "substantive audit" work already performed. Therefore the walkthrough is redundant and adds additional cost to the audit.

10. Is it appropriate to require that the walkthrough be performed by the auditor himself or herself, rather than allowing the auditor to use walkthrough procedures performed by management, internal auditors, or others?

No. It is not necessary that the auditor perform all the walkthroughs and should use management. Again, this is too broad and will no doubt be interpreted by the auditors as requiring walkthroughs of all processes regardless of significance. Also as stated above, the testing should not be required for all material or significant processes and or locations on an annual basis.

11. Is it appropriate to require the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year or may the auditor use some of the audit evidence obtained in previous years to support his or her current opinion on management's assessment?

The standards should be constructed so that the auditors are not required to perform detailed testing of all significant processes or locations on an annual basis. History of testing by both management and the auditors in prior years and prior quarters of the current year should be encouraged. In formulating an opinion on the financial statements (and internal controls for financial reporting) the auditor relies on prior experiences to determine scope and extent of work. Therefore, use of prior years work is essential and should be a part of determining scope in the current year.

12. To what extent should the auditor be permitted or required to use the work of management and others?

Auditors should be required to review the work of management and others in the process to a large extent. If performed properly, this will not only serve to control fees but also result in improved audit results. Many companies have continuous process improvements efforts. If done right, 404 compliance can be made easier, result in better audits, and benefit the company through lower fees. Moreover, the level of experience in a typical public accounting staff is such that reviewing the work of others is preferable to performing their own work blindly with very minimal experience and even less specific client knowledge.

13. Are the three categories of controls and the extent to which the auditor may rely on the work of others appropriately defined?

No. Be more specific! Control points # 2 and #3 performed jointly with the auditor and management or others lends credibility to control point #1 (the control environment). Therefore, use of management and others to evaluate the environment, risks, etc is and should be appropriate.

14. Does the proposed standard give appropriate recognition to the work of internal auditors? If not, does the proposed standard place too much emphasis and preference on the work of internal auditors or not enough?

No. However, PCAOB must clearly define in detail what is "sufficient" work for the auditor to perform so that inappropriate work is not performed and a reasonable level of comfort is attained. Many internal auditors perform work that go well beyond the scope of an external financial audit. However, much of this work goes unappreciated and unused given fee considerations and perceived scope of the external work. Moreover, the institutional knowledge developed by a good internal auditor goes largely unused and unappreciated.

15. Is the flexibility in determining the extent of reperformance of the work of others appropriate, or should the auditor be specifically required to reperform a certain level of work (for example, reperform tests of all

significant accounts or reperform every test performed by others that the auditor intends to use)?

No. Again, this will result in broad interpretation. PCAOB should be more specific in this area.

16. Is the requirement for the auditor to obtain the principle evidence, on an overall basis, through his or her own work the appropriate benchmark for the amount of work that is required to be performed by the auditor?

No. The auditor is and should be held responsible for the principle evidence. However, the process used to obtain that evidence is subject to many interpretations by the auditing profession. PCAOB should specifically define the benchmark.

17. Will the definitions in the proposed standard of significant deficiency and material weakness provide for increased consistency in the evaluation of deficiencies? How can the definitions be improved?

Yes. However, clearer definition is essential. Communicating to the Audit Committee should be done on only significant findings. Insignificant weaknesses or immaterial errors should not be the focus. Much time and money will be expended in determining what should be elevated to the Audit Committee. As regards Audit Committee effectiveness, "who" will set the standard? PCAOB should establish specific benchmarks for the evaluation.

18. Do the examples in Appendix D of how to apply these definitions in various scenarios provide helpful guidance? Are there other specific examples that commenters could suggest that would provide further interpretive help?

N0. For example, say a company has several large US locations and many of the transactions are processed centrally. From a materiality point of view all locations are significant and the centralized process is therefore significant. A transaction processing error at one location (assuming that it is detected and corrected) should not necessarily be relevant to the entire population of transactions and locations and thereby lead to a conclusion that the process and the location are not "in control".

19. Is it necessary for the auditor to evaluate the severity of all identified internal control deficiencies?

No. The auditor in the audit planning process should develop and draw on past experiences from prior years' audits. From that planning process the auditor should be able to evaluate and obtain comfort as to managements' evaluation of deficiencies.

20. Is it appropriate to require the auditor to communicate all internal control deficiencies (not just material weaknesses and significant deficiencies) to management in writing?

No. Only material or significant weaknesses should be communicated to management or to the Audit Committee as well.

21. Are the matters that the Board has classified as strong indicators that a material weakness in internal control exists appropriately classified as such?

Yes.

22. Is it appropriate to require the auditors to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting?

Yes. It is appropriate. However, the Board must carefully consider the consequences to management and the Board of Directors. Audit Committees rely on management and other sources, such as the independent auditor, to perform their oversight roles. Presentation of such an evaluation, especially if negative or presented incorrectly, could create issues between management and the Board that go beyond financial reporting. In my experience, sometimes the auditors are ignorant of monitoring and other internal controls that are the responsibility of the full board or another committees of the board. For the above reasons, it would be preferential to require the Audit Committees to perform a self-evaluation and review with management and the auditors and solicit feedback from both. This would then be similar to the governance requirements of Board self-evaluation required by the NYSE.

23. Will auditors be able to effectively carry out their responsibility to evaluate the effectiveness of the audit committee's oversight?

No. Public accountants do not have the requisite skills to perform such an evaluation. PCAOB should develop the criteria and benchmarks. That evaluation should be performed jointly with management and the Committee and not in a vacuum. PCAOB should be very specific in directing the evaluation. See comments to #22 above.

24. If the auditor concludes that ineffective audit committee oversight is a material weakness, rather than require the auditor to issue an adverse opinion with regard to the effectiveness of the internal control over financial reporting, should the standard require the auditor to withdraw from the audit engagement?

No comment. Both options have severe consequences. If a company has an ineffective Audit Committee, there would moat likely be other very significant issues for the Board to address. PCAOB should be more concerned with the accuracy and fairness of the evaluation.

25. Is it appropriate that the existence of a material weakness would require the auditor to express an adverse conclusion about the effectiveness of the company's internal control over financial reporting, consistent with the required reporting model for management?

No. The auditor should report only on material weaknesses as required in management's report. Again PCAOB must be very specific as to the definition of materiality.

26. Are there circumstances where a qualified "except for" conclusion would be appropriate?

No. If the definitions are clear and the standards for execution of the audit clearly defined, then management and the auditors should be able to conclude on the facts and issue the appropriate conclusion. However, PCAOB should give clearer guidance on disagreements over what is or is not material and significant and the resolution.

27. Do you agree with the position that when the auditor issues a nonstandard opinion, such as an adverse opinion, that the auditor's opinion should speak directly to the effectiveness of the internal control over financial reporting rather than to whether management's assessment is fairly stated?

If the auditors are allowed to issue a nonstandard opinion, then they should speak directly to financial reporting. However, as mentioned in #26, clear definition is needed. Also, PCAOB should clearly address resolution of different opinions between management and the auditors over material weaknesses. For example, should management in its report have the ability to disagree with the auditors' conclusion and if so, how should the format of such a dissent be articulated?

28. Should the Board provide specific guidance on independence and internal control-related non-audit services in the context of this proposed standard?

Yes.

29. Are there any specific internal control-related non-audit services the auditor should be prohibited from providing to an audit client?

Yes. All internal control work should be disallowed beyond formulating the opinion on the financial reporting control as part of the annual audit.

30. Are the auditor's differing levels of responsibility as they relate to management's quarterly certifications versus the annual (fourth quarter) certification, appropriate?

Yes. However, I do not agree with the conclusion that a promptly corrected material weakness need be disclosed.

31. Is the scope of the auditor's responsibility for quarterly disclosures about the internal control over financial reporting appropriate?

Yes. Again however, if the material weakness is promptly corrected I see no compelling need for disclosure.