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November 19, 2003

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

Re: PCAOB Rulemaking Docket Matter No. 008

Ladies and Gentlemen:

Thank you for the opportunity to comment on the Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of the Financial Statements* (the "Proposed Standard"). This Proposed Standard concerns attestation engagements pursuant to Sections 103(a)(2)(A)(iii) and 404(b) of the Sarbanes-Oxley Act of 2002 (the "Act"). On behalf of Intel Corporation, we offer the following comments with regard to the Proposed Standard.

EXECUTIVE SUMMARY

General Comment.

We believe it is important to retain focus on the Act's original objective of reinforcing "the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting."[1] Unfortunately, the prescriptive nature of the Proposed Standard could undermine the Act's objective by seemingly placing much of the burden of providing reasonable assurance on the shoulders of external auditors. Instead, we recommend the Proposed Standard be modified to reinforce management's role in assessing internal controls over financial reporting.

Reliance on the work of others.

We applaud the Public Company Accounting Oversight Board's ("PCAOB") sensitivity to cost-benefit considerations in its statement: "[t]he more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be."[2] However, we believe the totality of the Proposed Standard unnecessarily restricts the auditor's ability to rely on competent management and internal audit work. Specifically, the Proposed Standard states: "the auditor's own work must provide the principal evidence for the audit opinion."[3] The Proposed Standard then proceeds to bar the use of management and internal audit testing in the broad areas of: (1) "controls that are part of the control environment"; (2) "controls over the

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[1] Sarbanes-Oxley Act of 2002 §404(a)(1), Pub. L. No. 107-204, 116 Stat. 745.
[2] PCAOB Release No. 2003-017, Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* 8 (Oct. 7, 2003).
[3] *Id.* at 14.

period-end financial reporting process"; and (3) "controls that have a pervasive effect on the financial statements, such as certain information technology general controls . . . ."[4] Finally, the Proposed Standard limits the use of management and internal audit testing of "controls over significant nonroutine and nonsystematic transactions."[5]

The Proposed Standard should allow both internal and external audit to modulate the scope of required testing consistent with the quality of management's work as determined in the auditor's judgment. If management's work is sufficiently planned and executed, then duplicative testing imposes substantial costs on companies with questionable benefit for investors. Additionally, as discussed further below, while we do not support the PCAOB's proposal to characterize the internal control attestation as an audit, the concept of integrating the financial statement audit and internal controls attestation should be reinforced throughout the Proposed Standard. We expect there will be ample opportunity to leverage the financial statement audit to satisfy internal controls validation requirements.

Moreover, the Proposed Standard should allow broad reliance on internal audit's work where external audit determines internal audit is competent, objective, and sufficiently independent. As drafted, the Proposed Standard is even more restrictive than the current model used for financial statement audits under Statement on Auditing Standards No. 65.[6] For example, when conducting the financial statement audit, external audit routinely relies on internal audit to test IT general controls. The Proposed Standard should carry such reliance forward to the attestation work.

Introduction of new and broad terminology.

While we appreciate the PCAOB's efforts to clarify the definition of "significant deficiency," which is not currently well defined in the auditing literature, we believe the PCAOB's proposed definitions of both "significant deficiency" and "material weakness" capture an unnecessarily low and insignificant level of control deficiencies which were not within the intent of Congress when the Act was adopted, and also introduce significant ambiguities which will make it difficult for companies or external auditors to interpret and apply the definitions. This lowering of the reporting threshold, with its effect of inundating management and the audit committee with an overwhelming volume of low-level deficiencies, could unintentionally dilute management and audit committee focus on those deficiencies truly warranting their attention. Furthermore, we are concerned by language that indicates an accumulation of significant deficiencies, in and of itself, could lead to a material weakness. If the significant deficiency threshold is lowered and significant deficiencies are then accumulated to lead to a material weakness conclusion, the unintended result may be investor confusion, not insight, on the actual severity of internal controls deficiencies.

As an alternative to the PCAOB's approach, we recommend the Proposed Standard give companies and the external auditors latitude to exercise judgment in determining those deficiencies that are significant enough to be elevated to management and the audit committee, or disclosed in public filings, while using more well-established terminology to provide

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[4] *Id.* at A-38.
[5] *Id.*
[6] *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU § 322).

definitional guidance. Rather than introducing the term "inconsequential" in the significant deficiency definition, we recommend that the PCAOB use the well-understood concept of materiality in addressing the magnitude of both a significant deficiency and a material weakness, and use different degrees of likelihood to distinguish between the two. Specifically, we recommend that the definitions hinge on whether there is a reasonable possibility individual or aggregated deficiencies would lead to a material adjustment in the financial statements, in the case of significant deficiencies, and on whether it is reasonably likely the deficiencies would lead to a material adjustment in the financial statements, in the case of material weaknesses. Using terminology that is already well-interpreted in the auditing literature, Securities and Exchange Commission ("SEC") guidance and judicial decisions will give companies and auditors greater ability to apply the definitions in exercising their judgment.

In addition, we request the PCAOB avoid using terminology that appears to extend beyond the financial reporting controls scope of the SEC's rules. For instance, ineffective internal audit, risk assessment, and regulatory compliance functions are listed as examples of significant deficiencies.[7] Yet in many companies, these functions extend beyond the realm of internal controls over financial reporting.

Role of the audit committee.

We recognize and fully support the audit committee's critical role in corporate governance. The audit committee should ensure proper tone at the top and act as an escalation point, but because it is difficult for the committee to truly understand the detailed operation of the company, it should not be expected to engage in the lower levels of internal control. The audit committee should not be inundated with reports of mundane and immaterial deficiencies. Thus, the Proposed Standard should not require the auditor to report *all* deficiencies to the audit committee, but should instead require the auditor to exercise judgment to determine which issues are sufficiently significant to warrant audit committee notification. In exercising this professional judgment, the auditor should evaluate whether there are effective measures and escalation channels in place to provide appropriate management and audit committee visibility to significant deficiencies and material weaknesses. In summary, we believe the Proposed Standard should focus on proper reporting processes and escalation procedures as opposed to requiring the escalation of all deficiencies.

Furthermore, under Section 301 of the Act, "[t]he audit committee . . . shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer . . . ."[8] Therefore, there is an inherent conflict of interest with the external auditor evaluating the effectiveness of the audit committee.

Consistency with the COSO Framework.

The Proposed Standard aptly recognizes many of the inherent limitations of internal control over financial reporting; however, the Proposed Standard fails to include the critical cost-benefit limitation called out in the COSO Framework. The COSO Framework states: "Another limiting factor is that the design of an internal control system must reflect the fact that there are resource

[7] *Id.* at A-43.
[8] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

constraints, and the benefits of controls must be considered relative to their costs."[9] We request this, or similar, language be added to the inherent limitations section of the Proposed Standard.

In closing, we would like to reinforce that Intel fully supports management accountability for maintaining effective internal controls over financial reporting. The Proposed Standard should build on that ownership model and allow greater reliance on the thorough and competent work of both management and internal audit. Otherwise, costs are likely to escalate well beyond any benefits to be achieved.

We thank you for consideration of our views. We have also attached our responses to the PCAOB's 31 questions in Exhibit A. Please contact Jim Campbell at (503) 696-7931 if you would like any further information in connection with our comments.

Regards,

Jim Campbell
Corporate Controller
Intel Corporation

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[9] Committee of Sponsoring Organizations of the Treadway Commission ("COSO"), *Internal Control-Integrated Framework* 6 (1994).

EXHIBIT A
RESPONSES TO PCAOB QUESTIONS

Questions regarding an integrated audit of the financial statements and internal control over financial reporting:

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?

No. Pursuant to Section 404(b) of the Act, "each registered public accounting firm . . . shall attest to, and report on, the assessment made by the management of the issuer."[10] In doing so, the auditor is expressing a conclusion about the reliability of management's written assertion. To conclude on management's assertion, the auditor will need to perform sufficient attest procedures to reduce to a low level the probability of not discovering materially misstated assertions. But the level of testing would not be as extensive as that required in an "audit" of internal control over financial reporting, where it would be necessary for the auditor to opine on the effectiveness of the design and operation of controls.

We are concerned that the PCAOB's use of the term audit in place of attestation conveys an inordinate emphasis on independent testing. While we acknowledge the benefits of selective independent testing to validate management's assessment, non-value-added, duplicative testing needlessly increases costs to companies and investors. Additionally, calling this the audit of internal control over financial reporting makes it appear this is a stand-alone audit. Instead, we recommend the PCAOB select language that reinforces the concept of integrating the financial statement audit and internal controls attestation.

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?

While an absolute bar on separate engagements is theoretically unnecessary, in practice, separate engagements would be costly and inefficient. We therefore expect to use the same auditing firm for both the internal control attestation and the financial statements audit.

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?

Some companies may feel it is important to have this flexibility. This would not be a cost-effective approach for us, and we therefore have no issue with requiring that the same auditing firm conduct both engagements.

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[10] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

Question regarding the costs and benefits of internal control:

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?

As this question does not pertain to Intel, we have no comment on this matter. However, it should be noted that COSO's study of fraudulent financial reporting found:

> Relative to public registrants, companies committing financial statement fraud were relatively small. The typical size of the sample companies ranged well below $100 million in total assets in the year preceding the fraud period. Most companies (78 percent of the sample) were not listed on the New York or American Stock Exchanges.[11]

Question regarding the audit of internal control over financial reporting:

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. The PCAOB should leave it to the audit firm to determine the professional competencies and training necessary to execute the attestation in accordance with the Proposed Standard's framework. The PCAOB, however, should encourage audit firms to include COSO and other internal controls training in their curriculums. Additionally, it is important for the auditors to have the business context for the particular engagement in order to perform an internal controls evaluation effectively.

Questions regarding evaluation of management's assessment:

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?

While the auditor should leverage competent management work and the integrated financial statement audit to minimize redundant testing, we do support selective independent testing. This cost-sensitive approach will allow the auditor to satisfy his or her obligation to validate management's assessment and will encourage management to develop quality documentation and test procedures.

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[11] COSO, *Fraudulent Financial Reporting: 1987-1997 - An Analysis of U.S. Public Companies*, *available at* http://www.coso.org.

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

We also support the flexibility to tailor the form of the documentation to the individual company circumstances and to allow auditor judgment in evaluating the adequacy of the documentation.

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?

The auditor should evaluate the impact of inadequate documentation on internal control. As documentation is only one indication of good internal control, inadequate documentation should not automatically rise to the level of a significant deficiency, material weakness, or for that matter, a deficiency. Per the COSO Framework: "Many controls are informal and undocumented, yet are regularly performed and highly effective. . . . The fact that controls are not documented does not mean that an internal control system is not effective, or that it cannot be evaluated."[12]

Questions regarding obtaining an understanding of internal control over financial reporting:

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

First, we believe the Proposed Standard should give the auditor latitude to determine the appropriate scope of walkthroughs. Additionally, the Proposed Standard should reinforce the concept of integration. Wherever possible, walkthroughs should be conducted in a manner that simultaneously achieves the objectives of both the financial statement audit and internal controls attestation. Furthermore, as discussed in our answer to Question 10, the auditor need not personally conduct *all* walkthroughs but should instead be able to rely on walkthroughs performed by management and internal audit. Finally, certain processes do not lend themselves to walkthroughs so auditor judgment would be required to determine the appropriate test procedures.

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 would not be appropriate to require the auditor to personally conduct *all* walkthroughs. We believe the auditor should have the flexibility to vary the number and scope of the required walkthroughs based on the quality and completeness of management's documentation and internal audit's test procedures. In addition, the walkthrough strategy should capitalize on the integration of the financial statement audit and internal controls attestation.

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[12] COSO, *Internal Control-Integrated Framework* 73 (1994).

<u>Question regarding testing operating effectiveness:</u>

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?

While it is reasonable for the auditor to obtain annual *evidence* of the effectiveness of controls for significant accounts, the Proposed Standard should not require the auditor to obtain *direct evidence* on *all* accounts every year. Instead, the auditor should have the flexibility to rely on management's work and the ability to leverage accumulated learning from prior years. A more restrictive approach would increase costs with questionable benefit for investors.

In addition, the test plan should carefully consider the quality of management's assessment to determine the scope of testing required. Similarly, based on the independence and proficiency of the internal audit function, greater reliance could be placed on internal audit's testing.

<u>Questions regarding using the work of management and others:</u>

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

The Proposed Standard should allow both internal and external audit to modulate the scope of the required testing based on the quality of management's assessment. Moreover, the Proposed Standard should allow greater reliance on independent, competent testing by internal audit. If management's work and internal audit's testing are sufficiently planned and executed, duplicative efforts needlessly increase costs to companies and investors.

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

The categories are overly restrictive. To avoid non-value-added rework, the Proposed Standard should reinforce integration of the financial statement audit and internal controls attestation and should allow the auditor to flex the reliance level based on the competence and completeness of management's and internal audit's work.

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. As stated in our cover letter, the independent testing guidelines unduly restrict the use of internal audit's work. The Proposed Standard should allow broad reliance on internal audit's work where external audit determines internal audit is competent, objective, and sufficiently independent.

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)?

Additional restrictions are not necessary. The auditor should be able to use his or her professional judgment to determine the extent of reperformance.

16. Is the requirement for the auditor to obtain the principal 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. First, we would ask for a more robust definition of what would constitute principal evidence. This definition should recognize that principal evidence is composed of both quantitative and qualitative elements. Additionally, we note that an inflexible principal evidence benchmark would fail to recognize fact-specific circumstances. The auditor should utilize his or her professional judgment to vary reliance consistent with the quality of management's work and internal audit's testing. Where management has performed a quality assessment and internal audit has performed competent testing, the auditor should have the flexibility to rely more heavily on their work.

<u>Questions regarding evaluating results:</u>

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?

As stated in our cover letter, we recommend the Proposed Standard give companies and external auditors latitude to exercise judgment in determining those deficiencies that are significant enough to be elevated to management and the audit committee, or disclosed in SEC filings. It is important though, to promote consistency in exercising this judgment, that the rules provide adequate definitional guidance using terminology that is already well-interpreted in the auditing literature, SEC rules and interpretations, and judicial decisions. We believe that Congress intended the Act's reporting and disclosure requirements related to significant deficiencies and material weaknesses to apply to serious control issues that run real risks of causing significant financial reporting issues, and the definitions set forth in the Proposed Standard instead reach immaterial and insignificant control issues. Consequently, if these definitions are adopted, we believe audit committees and investors will be inundated with irrelevant information, increasing the risks that audit committees will fail to fully appreciate and follow up on the truly serious issues and investors will simply be confused. We do not believe the "more than remote" and "more than inconsequential" terminology used in these definitions will promote increased consistency, because we believe that the lines between "slight" and "more than slight", and between "inconsequential" and "more than inconsequential" are very difficult to draw and even reasonable issuers acting with the best of intentions will inevitably interpret those terms differently in similar fact situations.

As an initial matter, by introducing the term "more than inconsequential" in the description of a significant deficiency, the PCAOB has created unnecessary ambiguity. It is not at all clear what this term means, or where the line is between something that is completely inconsequential and something that is slightly less, or in the PCAOB's terminology, "more than" inconsequential. Both definitions should hinge on whether the deficiencies at issue could lead to a material adjustment in the financial statements, and the distinction between a significant deficiency and a material weakness should be determined by reference to the degree of likelihood that a material financial reporting issue will result.

The use of "more than remote" as the degree of likelihood in the significant deficiency and material weakness definitions establishes an unnecessarily low bar for control deficiencies that would require reporting to the audit committee or a conclusion that the company's controls are ineffective.[13] We believe the PCAOB's definitions are inconsistent with the definitions of material weakness and reportable condition (from which the term "significant deficiency" appears to have been derived) that existed in the audit literature at the time the Act was passed and therefore must be afforded due consideration in determining Congressional intent. The definition of material weakness is a "reportable condition in which the design or operation of one or more of the internal control components **does not reduce to a relatively low level** the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions."[14] Reportable conditions are "matters coming to the auditor's attention that, in his (or her) judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of the internal control, which **could** adversely effect the organization's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements."[15] The auditing literature already contains substantial guidance on the factors that should be considered in determining whether there is a reportable condition or a material weakness and we do not believe the PCAOB should supplant that guidance in these rules.

We believe it would be more appropriate for the PCAOB rules to use the existing terms "reasonably possible" and "reasonably likely" in these definitions. The FAS 5 definition of "reasonably possible" is more than remote but less than likely, and the SEC's definition of "reasonably likely" is more than merely possible but not necessarily more likely than not.[16] By using a range, these definitions provide better guidance for the exercise of judgment when evaluating the seriousness of control deficiencies.

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[13] We have the same concern with the "more than remote" threshold as used in other parts of the Proposed Standard, such as paragraph 61addressing the definition of a significant account. We strongly urge the PCAOB to address the difficulties of determining when the chances of an event occurring are more than slight, and to revise these references throughout the Proposed Standard to, at minimum, a "reasonably possible" standard.

[14] Statement on Auditing Standards No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU § 325) (emphasis added).

[15] *Id.* (emphasis added).

[16] See SEC Release No. 33-8182; 34-47264 - Disclosure in Management's Discussion and Analysis ("MD&A") about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, note 99 and related text; SEC Release Nos. 33-8185; 34-47276 - Implementation of Standards of Professional Conduct for Attorneys, note 50 and related text.

We note that in SEC Release No. 33-8182; 34-47264 - Disclosure in Management's Discussion and Analysis ("MD&A") about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, the SEC decided to adopt a "reasonably likely" standard for disclosure of off-balance sheet arrangements in MD&A, after first considering an earlier proposed "higher than remote" standard. The "higher than remote" standard was initially proposed by the SEC because Section 401(a) of the Act refers to disclosure of off-balance sheet arrangements that "may" have a material future effect on the registrant. In its commentary on why it chose to adopt the "reasonably likely" threshold, the SEC noted that this standard reached the information most relevant to investors, noted the difficulties issuer would have in applying the "higher than remote" threshold, and concluded: "We believe that the 'reasonably likely' threshold best promotes the utility of the disclosure requirements by reducing the possibility that investors will be overwhelmed by voluminous disclosure of insignificant and possibly unnecessarily speculative information." We note the use of the word "could" in the reportable condition definition and Section 401(a)'s use of the word "may," and the SEC's adoption of a "reasonably likely" threshold in the Section 401(a) context.

In light of the SEC's interpretation of Section 401(a), it is possible to conclude that the term "could" in the reportable condition definition translates into a "reasonably likely" threshold for significant deficiencies, and the threshold for material weaknesses should be even higher, such as a "more likely than not" or "probable" standard. However, we believe that the term "does not reduce to a relatively low level" from the existing material weakness definition is inconsistent with the use of a threshold higher than reasonable likelihood. Therefore, we think thresholds of "reasonable likelihood" for material weaknesses, and "reasonable possibility" for significant deficiencies are the most consistent with existing literature and interpretations, and we also believe these thresholds will promote greater certainty and reduced compliance burdens for issuers, while avoiding the risk of inundating audit committees and investors with voluminous and irrelevant information.

In conclusion, we recommend that the definitions hinge on whether there is a reasonable possibility individual or aggregated deficiencies would lead to a material adjustment in the financial statements, in the case of significant deficiencies, and on whether it is reasonably likely the deficiencies would lead to a material adjustment in the financial statements, in the case of material weaknesses.

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?

Providing examples in the Proposed Standard would perhaps be useful, but the examples in the Proposed Standard are limited in their usefulness. First, in the two examples of a significant deficiency, the PCAOB indicates compensating controls may prevent a significant deficiency from rising to the level of a material weakness. We agree with that premise but would also note that such controls could keep a deficiency from becoming a significant deficiency. Additionally, it is difficult to understand why Example D-1 (Reconciliations of Intercompany Accounts Are

Not Performed on a Timely Basis) would rise to the level of a significant deficiency or material weakness. Such intercompany accounts are eliminated in consolidation.

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

The auditor should only elevate internal control deficiencies where the significance and materiality are at an appropriately high level. There should be a threshold of significance below which the auditor relies on management

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, refer to our response to Question 19.

Furthermore, as discussed in our cover letter, the Proposed Standard sets up an unwarranted escalation of non-significant and non-material items to the audit committee. "The auditor . . . is required to communicate to the company's management, in writing, *all* internal control deficiencies of which he or she is aware and to *notify* the audit committee that such communication has been made."[17]

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

We agree with the majority of the examples provided they are merely illustrative and do not impede the auditor's ability to take the facts and circumstances of each case into account. However, in some cases, the examples of ineffective internal audit, risk assessment, and regulatory compliance functions would extend beyond the Act's scope of financial reporting controls. In addition, in accordance with our response to Question 22, we would strike the example of ineffective audit committee oversight as the external auditor could have difficulty objectively evaluating the audit committee.

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?

No. There is the potential for compromised independence with the proposed evaluation process. An auditor cannot be expected to objectively evaluate the effectiveness of the committee that carries the responsibility for its continued employment and compensation.

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

No. Refer to our answer to Question 22.

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[17] PCAOB Release No. 2003-017, Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* 16 (Oct. 7, 2003) (emphasis added).

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. We do not believe this would be an appropriate response.

<u>Questions regarding forming an opinion and reporting:</u>

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?

In answering this question, we are assuming the PCAOB is referring to a situation where a material weakness exists as of the end of the period. In that circumstance, the SEC's rules make it clear that: "[m]anagement is not permitted to conclude that the [company's] internal control over financial reporting is effective . . . ."[18] To avoid confusing investors, the auditor should also express an adverse conclusion about the effectiveness of the company's internal control over financial reporting.

If, however, the material weakness has been identified and *corrected* prior to the end of the period, both management and the auditor could conclude the company's internal control over financial reporting is effective.

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

Yes. We believe qualified "except for" conclusions would actually allow for more meaningful public disclosure in certain cases. For instance, mergers and acquisitions occurring close to year end could warrant an "except for" conclusion. An adverse opinion in that circumstance could mislead the public to believe internal controls are not effective, when in fact, this is just a case of having inadequate time to fully assess the internal controls. Another example might be a case where a subsidiary representing an insignificant percentage of the parent's equity has a material weakness. As the Proposed Standard is drafted, the auditor would be required to issue an adverse opinion. However, this adverse opinion would do little to inform investors of the true nature of the deficiency or its effect on the overall control environment of the parent corporation.

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[18] Final Rule: Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Report*s*, Securities and Exchange Commission Release Nos. 33-8238, 34-47986, IC-26068, 68 Fed. Reg. 36663 (June 18, 2003).

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?

Consistent with our answer to Question 1, we believe the auditor should conclude on management's written assertion, not opine on the effectiveness of the internal controls over financial reporting. The opinion would speak to management's assessment and the basis of disagreeing with management's assessment would be the auditor's concern about the internal controls.

Questions regarding auditor independence:

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

No. It should be left to the discretion of individual boards of directors, based on the existing SEC guidance. Many boards, including Intel's, already supply such guidance.

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

Yes, but we believe the existing SEC guidance is sufficient.[19]

Questions regarding auditor's responsibilities with regard to management's certifications:

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

In general, yes. However, the written representation requirements in paragraph 128 on page A-44 largely replicate the signed 302 certifications. The notarized 302 certifications should be sufficient representation.

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

Our answer to this question depends on the PCAOB's interpretation of "limited procedures."[20] If observation is broadly construed to include walkthroughs, it is an unnecessary change.

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[19] *See* Final Rule: Strengthening the Commission's Requirements Regarding Auditor Independence, Securities and Exchange Commission Release Nos. 33-8183, 34-47265, 35-27642, IC-25915, IA-2103, 68 Fed. Reg. 6010-17 (February 5, 2003).

[20] PCAOB Release No. 2003-017, Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* A-61 (Oct. 7, 2003).

Additionally, given there is no audit of the quarterly financial statements, walkthroughs would be inconsistent with the integration concept.