financial executives international

November 20, 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:

The Committee on Corporate Reporting ("CCR") of Financial Executives International ("FEI") would like to thank you for this opportunity to comment on the Public Company Accounting Oversight Board's ("the Board") proposed auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("the proposed standard"). FEI is a leading international organization of 15,000 members, including Chief Financial Officers, Controllers, Treasurers, Tax Executives and other senior financial executives. CCR is a technical committee of FEI, which reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. This document represents the views of CCR and not necessarily those of FEI.

CCR would like to recognize the Board members and staff for their diligent work in preparing this proposal. FEI has long been a supporter of management's responsibility for creating and maintaining an effective control environment. We take this responsibility seriously and believe that the management certification process alone will significantly improve the strength of internal control. While we acknowledge that an external review of management's assessment will provide additional assurances, we believe the proposed standard requires the auditor to perform attestation procedures that are not only beyond the scope of Sections 103 and 404 of the Sarbanes-Oxley Act ("the Act"), but will provide questionable additional benefit to financial statement users at a high financial and time-consuming cost.

In summary, we are pleased that the proposed standard appears to have incorporated some of the views previously expressed by CCR. Additionally, we would agree that from a high level, the proposed standard seems to represent a balanced approach. However, we have significant concerns on several sections of the proposed standard and we believe that if it is implemented in its current state, the level of duplicative testing and the resulting impact on business operations will result in unnecessary costs to investors in public companies that are far beyond the benefits expected.

Specific responses to the Board's questions on the proposed standard are included in Attachment A. In addition to these responses, we respectfully submit the following general observations for the Board's consideration:

- We believe that the standard as currently drafted creates a situation where the costs far outweigh the benefits of implementation. Given the limited level of reliance that the external auditor can place on the work of others (as discussed further below), the resultant level of duplicative testing will cause numerous interruptions to the operations of our businesses. These interruptions alone are very costly; however, when coupled with the cost of internal and external resources to support management's assertion and the fees associated with the increased work to be performed by the external auditor, the costs are far beyond the benefits attained. Most CCR companies estimate an increase of approximately 30% to 50% in audit fees as a direct result of the required audit of internal control over financial reporting. Most would not mind the cost if we believed that the work being done would really improve controls or prevent future corporate scandals similar to those experienced over the past few years. We believe the work required by the final standard should be focused on the significant issues such as business risk and fraud prevention and detection.

- We believe that management's assertion of internal control effectiveness must be thoroughly supported by annual testing. However, we do not agree that the auditor's review must be equally thorough, annually. Given that the Act requires the auditor to evaluate management's process and assertion, we do not believe the auditor must independently evaluate all controls annually, but rather should rotate its efforts in assessing management's process. This rotation will prove cost efficient and support user's interests.

- We also believe that the proposed standard does not allow the auditor to exercise sufficient judgment and in particular, use as a basis, prior audit experience with their clients. The proposed standard is prescriptive, causing auditors to perform the same level of testing at companies with strong control structures as would be performed at those with weak control structures. For example, in the area of appropriate levels of testing, we believe that the proposed standard should grant the auditor more latitude on testing strategies and rotating tests of controls, dependent upon the auditor's evaluation of the overall control environment of the organization. Specifically, in situations where the control environment is very strong, the level of detail testing of the controls over routine data processing should be permitted to be minimal, or in such situations where processes remain unchanged, the auditor should be able to use his or her judgment in determining what level of testing would be appropriate (e.g., rotation or obtain an update of their understanding followed by a walkthrough of the process). Further, we are concerned that the proposed standard has been too prescriptive in requiring the auditor to evaluate ***all*** controls addressing the risk of fraud. The auditor should be able to exercise judgment in this area as well.

- The Board's three-tiered approach to reliance on the work of others, while intending to be helpful, has the effect of allowing very little reliance on the work of others or restricting such reliance to only routine transaction processing. Specifically, we do not believe the Board has adequately supported its proposed requirements with respect to the auditor's required evaluation of IT general controls and the financial statement closing process with no reliance upon internal audit or management's procedures. These are pervasive areas that will lead to significant levels of repetitive, detailed testing by numerous parties if the proposed standard is adopted.

- As stated above, we believe that the proposed standard places very little value on the work of a company's management and its internal auditors. In doing so, the standard requires that the external auditors reperform a significant level of testing for which the results of identical testing are easily obtainable from management. We would like the Board to recognize that many management groups have significant financial reporting controls expertise and operate within strong internal control structures. High quality management work should limit the scope of required testing by both internal and external audit. Further, we would like the Board to be more flexible in terms of how much reliance the external auditor can place on the work of both management and the internal audit function. As drafted, the proposed standard seems to equate management testing with that of internal auditors. A properly functioning internal audit function is competent, objective and independent from management. As such, the proposed standard should allow for a significant amount of reliance on the work performed by internal auditors, especially in areas beyond routine transaction processing. Moreover, the work of an internal audit function adds accountability to a company's control structure, which in turns causes the control execution to be more consistent.

  The relationship of the internal audit function to the external audit of financial statements is already addressed in detail within the Statement of Auditing Standards. No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* ("SAS 65"). CCR believes that the relationship defined in SAS 65 is appropriate and does not need to be redefined. Rather, the Board's standard should utilize the provisions of SAS 65 to determine the minimal additional audit steps to evaluate internal control over financial reporting. Further, CCR is concerned that if unchanged, the apparent diminished recognition of internal audit's vital role could eventually lead to decreased reliance on the internal audit function as it relates to the audit of the financial statements. We believe this diminished recognition of the internal audit function is not intended by, and is contrary to, the SEC's ruling under Section 404 of the Act.

- We believe that the proposed standard should expand on the requirements for the auditor to execute a walkthrough. In doing so, the standard should explicitly state when and where a walkthrough is needed. We believe walkthroughs are only one method in which to achieve audit evidence and, therefore, should not be mandated for every significant process. Further, most routine processes lend themselves easily to walkthroughs, whereas other processes that are non-routine and involve a significant amount of judgment do not. To that end, a more detailed explanation of what constitutes a walkthrough in such circumstances would be helpful. Again, this is an area where the auditor should be able to exercise significant judgment.

- We agree philosophically that effective oversight by the audit committee is an important component of the control environment. However, we do not believe that the auditor is in an objective position to evaluate the audit committee. Considering that the audit committee makes the decisions regarding hiring and firing of the external auditors, such an evaluation would put the auditor in an awkward position. This position could cause the auditor to be unwilling to conclude that the committee is ineffective. Further, and perhaps more importantly, we believe that a properly functioning audit committee is comprised of individuals with a much broader expertise than that held by the professional auditor. Accordingly, we do not respectfully believe that most external auditors carry the level of expertise necessary to effectively evaluate an audit committee.

- We would like to commend the Board for their conclusions that only material weaknesses be reported publicly. However, the proposed standard should be more explicit in defining how a deficiency elevates to a significant deficiency and a significant deficiency to a material weakness. We believe the Board should further define or clarify what the term “inconsequential” means as it relates to the definition of a significant deficiency. Further, we believe that internal control over financial reporting is a network of controls with multiple levels. To this point, the standard should require the auditor to evaluate the presence of other compensating controls that would prevent a misstatement of the financial information. We are concerned that the examples outlined in Appendix D of the proposed standard are too narrow and do not appropriately consider materiality. These examples only focus on the first layer of controls, rather than considering the entire structure as a whole. We believe that in most organizations, there would likely be other mitigating or compensating controls in place to detect material misstatements. We believe that examples of compensating controls that keep a deficiency from elevating would be helpful.

We truly appreciate the opportunity to comment on the Board’s proposed standard and the Board’s consideration of our concerns. Moreover, we welcome the opportunity to discuss these issues at your convenience. Finally, we would like to encourage the Board to issue the final standard as expeditiously as possible, especially considering the significant time constraints for our June 30, 2004 filers. If you have questions regarding this letter, please feel free to contact Frank Brod at (989) 636-1541 or Kate Asbeck at (607) 974-8242.

Sincerely,

Frank Brod
Chair, Committee on Corporate Reporting
Financial Executives International

Kate Asbeck
Chair, PCAOB Subcommittee
Committee on Corporate Reporting
Financial Executives International

Attachment A
Responses to Specific 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?*

    Yes, we believe it is appropriate to refer to the auditor's attestation as the audit of internal control over financial reporting.

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?*

    Yes, we believe an audit of internal control over financial reporting should be integrated with an audit of the financial statements and therefore, the same auditor should perform both audits.

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?*

    As stated in the response to question two above, we believe that the same auditor should perform both the audit of the financial statements as well as the audit of internal control over financial reporting.

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?*

    We believe the standard should further explain the importance of the control environment (i.e., financial leadership with a high level of integrity, etc.) as it relates to the impact of the testing and documentation requirements of the proposed standard. In small to medium sized companies, the senior financial leadership is much closer to the operations of the entity and, as such, various levels of control are not as necessary.

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, we believe the Board should leave it to the audit firm to determine the professional competencies and training necessary to execute the attestation in accordance with the Standard's framework. The Board, however, should encourage audit firms to include COSO and other internal controls training in their curriculums. Similar to an audit of financial statements, it is important for the auditors to have the business context and industry perspective for that particular engagement in order to perform an internal controls evaluation effectively.

<u>*Questions regarding evaluation of management's assessment:*</u>

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?*

   CCR would like to reiterate its position that the auditor should be evaluating management's process in arriving at management's assertion, rather than performing a duplicative level of testing to support the auditor's own conclusions. We respectfully disagree with the Board's interpretation of Section 103 (a) (2) (A) (iii) of the Act, that the auditor must be able to agree that internal controls are operating effectively, rather that they are designed effectively. Therefore, we do not believe the scope of the audit of internal control over financial reporting is appropriate.

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

   We believe that guidance for the auditor is appropriate; however, we also believe that the standard should leave room for the auditor's professional 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?*

   We believe that the standard should allow for the auditor to exercise judgment around the appropriate level of documentation of internal control over financial reporting. We do not believe that a "one size fits all" approach is appropriate in this case. Many different factors, such as size and complexity of the organization, compensating controls and senior management tone over the control environment should influence the level of documentation necessary. Furthermore, we believe that inadequate documentation is ***at most*** a deficiency, as a lack of documentation alone will not lead to any misstatement of financial information. It is the lack of actual controls, not the documentation of the controls, which may lead to misstatements.

<u>Questions regarding obtaining an understanding of internal control over financial reporting:</u>

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

   We believe that, for routine processes with high transaction volumes, a walkthrough of the process is an important procedure. However, as mentioned in the body of our letter, there are numerous processes that will not lend themselves easily to walkthroughs. Accordingly, a blanket requirement for walkthroughs of all significant processes may not achieve the desired objectives. Again, we believe the auditor should have the flexibility to exercise judgment about the appropriate procedures to be performed for specific accounts and assertions. Review of management's policies and procedures, interviews with personnel and transaction reviews are other methods that can be used to meet this same objective.

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?*

    We believe the Proposed Standard should allow for more auditor judgment in determining what types of work the auditor can rely upon to support their attestation report. It is not clear why the Board believes such procedures can only be performed by the auditors in all cases and challenge whether work performed (and documented) by others would not meet the same objective.

<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?*

    We believe that in many organizations, the controls are substantially unchanged from year to year. In such circumstances, the auditor should be able to utilize his or her cumulative audit knowledge and judgment in determining the appropriate level of testing. In a well-controlled environment, an update of the auditor's understanding along with minimal testing should be appropriate.

<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?*

    As outlined in the body of our letter and in response to question 10 above, we believe that the Board has not fully recognized the competence and objectivity of most internal audit functions. The practice of utilizing the work of the internal auditor should be permitted to a much greater extent than currently considered in the proposed standard. Furthermore, in certain routine processing, the auditor should be able to use the work of management, obviously to a lesser degree than that of an internal auditor, but still to a substantial degree.

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

    We believe that the categories of controls are appropriate. However, we would argue that the examples of what is categorized into each section are too restrictive. For instance, the auditor should be able to rely heavily on the walkthroughs performed by others, the work of an internal audit specialist and, in some cases, management, on IT general controls, and the work of others on the routine portions of the financial statement close process.

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?*

    As previously stated in the body of the letter and in response to question numbers 10 and 12 above, the standard does not give appropriate recognition to the work of the internal auditors. Further, the Board has seemed to equate the work of management and the work of the internal auditor. As stated before, in a properly functioning internal audit system, the internal audit function is both independent and objective. The determination as to what level of reliance the auditor can place on the work of the internal auditor is already addressed in SAS 65 for audits of financial statements and should be no different in the audit of internal control over financial reporting. To reiterate, this standard ***does not place enough emphasis*** on relying on the work of the internal auditor.

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)?*

    We believe that the standard should allow for auditor judgment in determining the extent of reperformance necessary.

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?*

    We do not believe this requirement is appropriate. We caveat this response by reiterating our previous point that we believe the auditor's responsibility under Section 404 of the Act is to evaluate management's process in arriving at their conclusions as to the effectiveness of internal control over financial reporting. If this requirement remains in the final standard, we encourage the Board to provide a more robust explanation of what is meant by "principal evidence".

<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?*

    We believe that the definitions in the proposed standard are appropriate. However, we also believe that the standard should outline the considerations of other controls within the control structure that could prevent a deficiency from becoming a significant deficiency, and a significant deficiency from becoming a material weakness. Additionally, we believe the introduction of the new term "inconsequential" in the description of a significant deficiency has created unnecessary ambiguity. Instead, the auditor should have the responsibility to exercise his or her professional judgment in determining those deficiencies to be reported to the audit committee.

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?*

    As discussed in the body of our letter, we believe that the examples in Appendix D should be expanded to further explain situations where controls in place would keep a deficiency from elevating to the next level. Furthermore, the examples of significant deficiencies include an ineffective risk assessment and regulatory compliance functions. These appear to extend beyond the scope of financial reporting.

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

    We agree that it is important for the auditor to evaluate all identified 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?*

We believe that the standard should allow for auditor judgment in determining which deficiencies should be reported to management. The auditor does not report all findings in a financial statement audit, especially findings of insignificant value. Accordingly, using the same logic, the auditor should not be required to report ***all*** deficiencies to management. Such required reporting would likely carry a cost that is beyond the benefits gained.

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 do not disagree with most of the indicators mentioned in the proposed standard. However, considering that both Section 404 of the Act and the proposed standard focus on the internal control over financial reporting and not on the controls related to compliance with laws and regulations and controls related to efficiency of operations, the indicator related to ineffective regulatory compliance seems out of scope with the Act.

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?*

    We do not disagree philosophically with the notion that effective oversight by the audit committee is an important component of the control environment. However, we do not believe that the auditor is in an objective position to evaluate the audit committee. This is primarily due to the fact that the audit committee has the responsibility for hiring and firing the external auditor.

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

    As discussed in our response to question number 22, we do not believe that the auditor is in an objective position to evaluate the audit committee as a result of the fact that the audit committee has the responsibility for hiring and firing the external auditor.

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?*

    We do not believe that 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?*

> We believe that this requirement is appropriate only if the material weakness has not been corrected prior to the "as of" date in management's assessment.

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

> We believe that, in certain circumstances, an "except for" conclusion may be appropriate. Such circumstances may include an acquisition completed within a short timeframe of a fiscal year end.

27. *Do you agree with the position that when the auditor issues a non-standard 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?*

> We believe that the standard should require the reports to be consistently directed either at management's assessment of internal control over financial reporting or the internal control over financial reporting itself.

<u>*Questions regarding auditor independence:*</u>

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

> We believe that all parties would benefit from additional guidance in this area.

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

> We believe that the external auditor should be prohibited from performing any significant work that assists management in arriving at its assessment of the internal control over financial reporting.

<u>*Questions regarding auditor's responsibilities with regard to management's certifications:*</u>

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

We believe that the differing levels of responsibility are appropriate in this case. The auditor's quarterly requirements should be limited to inquiry only and focused very heavily on negative assurance.

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

We agree with the scope of the auditor's responsibility for quarterly disclosures about the internal control over financial reporting.