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FINANCIAL REPORTING COMMITTEE

November 21, 2003

Via email: comments@pcaobus.org
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Attention: Office of the Secretary

Re: PCAOB Release No. 2003-17; 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

Ladies and Gentlemen:

This letter is submitted on behalf of the Financial Reporting Committee of The Association of the Bar of the City of New York (the "Committee") in response to Release No. 2003-17, October 7, 2003 (the "Release"), in which the Public Company Accounting Oversight Board (the "PCAOB") announced a proposed auditing standard for Internal Control Over Financial Reporting (the “proposed standard” or “proposal”). Our Committee is composed of lawyers with diverse perspectives on securities issues, including members of law firms, counsel to major corporations, investment banks, and institutional investors.

Introduction

The Committee supports the PCAOB’s objective of creating an integrated standard for the purpose of performing an audit of internal control over financial reporting in conjunction with an audit of the financial statements. The recommendations that follow are offered with the intention of revising definitions which could lead to unintended outcomes with costs to companies and shareholders that far exceed the benefits to investors and to make suggestions that further support the goal of an efficient, effective, and integrated audit through principles-based rulemaking as opposed to overly rigid, technical rules. While our responses refer to specific question numbers, we have organized our responses not by the sequential numbering of the PCAOB's questions, but rather by the importance we believe each topic deserves.

1. Overview.

We request that the PCAOB consider four main themes:

- Certain of the key definitions have thresholds that are too low.
- Certain of the rules, particularly those related to the identification of fraud, should be more principles-based and less rigid to allow external auditors to assess the facts and circumstances of each individual situation and to exercise their professional judgment in light of these facts and circumstances.
- Certain of the required activities of auditors are inappropriate, beyond their expertise and impose inherent conflicts of interest that will impede the relationship between the audit committee and the auditor and undermine the enhanced authority of the audit committee granted by Sarbanes-Oxley.
- Auditors should be given greater ability to rely on internal audits where, in their professional judgment, such reliance is appropriate.

A. Certain Definitions Should Have Higher Thresholds.

Although the PCAOB may not be able to perform a cost impact analysis as to the new requirements to be implemented in the proposed standard, we believe the PCAOB should consider the impact of definitions that we believe include excessively low thresholds by which to measure deficiencies. A complete discussion of our proposed revisions to the thresholds definitions is included below. We request that the PCAOB keep in mind while reviewing our comments that the proposed requirements will be broadly applied and will not be limited to issuers and auditors with unlimited resources.

B. Rules, Particularly Those Related to the Identification of Fraud, Should Be Less Prescriptive and Rigid and More Principles-Based to Allow External Auditors to Exercise Professional Judgment.

We believe the general preference of the Securities and Exchange Commission ("SEC") for principles-based accounting over rules-based accounting should extend to some of the new PCAOB proposals identified below. In our opinion, certain proposed standards are too prescriptive and rigid and we respectfully suggest that those technical, rigid rules be replaced with more principles-based rules under which certain facts and circumstances would be identified as factors to be considered by the external auditor rather than as items mandating certain findings. The proposal states repeatedly that external auditors must be able to exercise judgment so that their procedures adapt to the size and complexity of each public company. We respectfully submit, however, that the proposal in certain areas does not adequately allow exercise of that professional judgment because in many instances the rules are too mechanical in that they mandate certain findings and are more "check-the-box" in approach rather than allowing the external auditor to give appropriate consideration and weight to the items specified in the proposed rules.

For example, the proposal specifies a rigid list of circumstances in which an external auditor must find at least a significant deficiency and provides that an auditor should consider those circumstances as a strong indicator of a material weakness. We believe such a rigid list would detract from the ability of external auditors to exercise their professional judgment in a meaningful manner.

We believe mandating annual walkthroughs of **all** of the company's significant processes for **all** types of transactions and events, both recurring and unusual, is excessively prescriptive. Also, the extent to which external auditors must review management's documentation should be determined in part by the external auditors using the PCAOB's principles on how to make that determination, not by rigid rules that dictate the degree of review required.

The SEC Fortune 500 review resulted in a substantial number of financial restatements by corporations to reflect the current SEC policy on identification and aggregation of segments. Applying the proposal, the external auditor may be required to automatically label a company as having a significant deficiency or material weakness in financial reporting even though the segment reporting was not intentionally misleading or fraudulent, but instead improperly aggregated in light of guidance released after the publication of the financial statements in question. We believe such a result would be inappropriate and perhaps even unfair. External auditors should be guided by the principle that the factors surrounding the need for a restatement should be considered in determining whether a significant deficiency or material weakness exists. There should not be an arbitrary rule that all restatements must fall into one of those categories without having the external auditors exercise their professional judgment in considering the circumstances surrounding the restatement. A restatement reflects an issue in a prior reporting period; it should not automatically result in a significant deficiency or material weakness in subsequent periods.

Similarly, we respectfully submit that the identification of fraud *of any magnitude* as an automatic significant deficiency and a strong indicator of a material weakness is too rigid and arbitrary. The magnitude of the fraud, the length of time over which the fraud was committed and the method of its discovery are all factors that should be considered by external auditors in determining whether a significant deficiency exists. If fraud is detected through existing internal control procedures and it is determined that the fraud in question was isolated, not material to the company and was not committed over a lengthy period of time, that may in fact evidence proper internal controls. As stated in the proposed standard, there are both preventive and detective controls, and the discovery of fraud is an accomplishment of the detective control system. Accordingly, we submit that the external auditors should be able to consider discovery of the fraud by the internal control system as a mitigating factor.

In our opinion, the appropriate principle should be that circumstances surrounding a finding of fraud should be examined by external auditors and they should use their professional judgment about the circumstances surrounding and the seriousness of each fraud. Using that judgment, the external auditors will likely determine that a fraudulent act committed by a senior member of a multinational retail chain's internal accounting staff indicates a greater likelihood of a serious problem than a single double billing fraudulent act related to an airline ticket reimbursement committed by a senior marketing manager. The latter does not indicate a significant deficiency and possibly a material weakness, whereas the former may very well so indicate.

Proposed Rule: Paragraph 126 -- "Each of the following circumstances should be regarded as at least a significant deficiency and is a strong indicator that a material weakness in internal control over financial reporting exists," and continues to list said circumstances.

Suggested Revised Rule: "In each of the following circumstances, *the external auditor should conduct appropriate inquiries and procedures to determine whether a significant deficiency, and possibly a material weakness, exists*."

2. Definitions.

Questions 17-18: 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? 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?

Considering that the proposal revolves around identifying significant deficiencies and ultimately material weaknesses in the internal control of financial reporting, we feel most strongly about implementing definitions with realistic thresholds that are principles-based and act as proper filters for identifying internal deficiencies.

First, both terms center on the standard of "remote likelihood," and refer to the definition of "remote" in SFAS No. 5. SFAS No. 5 defines "remote" as the "chance of the future event or events occurring is slight." It is our belief that such a threshold is far too low, and not only differs from the "reasonable assurance" standard required by management that was adopted by the SEC in Release No. 33-8238 and reflected under COSO and Codification of Statement on Auditing Standards AU §319.18, but would also make for a condition in which every auditor would be forced to create a laundry list of deficiencies, no matter how small or insignificant.

This lies in stark contrast to the AICPA standard of a "reportable condition," which allows the auditor to use professional judgment in determining whether a significant deficiency exists. Under the current state of the proposal, the PCAOB would essentially be tying the AICPA auditing standards to the lowest threshold of probability for a material misstatement under SFAS No. 5. Creating such a definition for "significant deficiency" would have consequences that lower the bar across all auditing procedures.

The possibility of human error or inadvertent misjudgment at every level of preventive or detective control would make it difficult, and nearly impossible, to categorize even the most stringent internal control system as reducing possibility to "slight." We believe that even in corporations with the most effective internal oversight, the chances of a material misstatement can be reduced only to "probably not," a definition that follows most closely the "reasonably possible" standard of SFAS No. 5, which is defined to mean "the chance that a future event or events occurring is more than remote but less than likely." Even at this level, however, we believe that many of the significant deficiencies identified will not be material, but nevertheless may cause auditors to issue unwarranted adverse opinions or refuse to issue an opinion at all. Investor confidence will not be restored in financial reporting of public companies if well-managed companies with robust internal controls are not able to meet unnecessarily strict and inadequately differentiated standards.

Probable	The future event or events are likely to occur.
Reasonably possible	The chance of the future event or events occurring is more than remote but less than likely.
Remote	The chance of the future event or events occurring is slight.

The term "inconsequential" in the definition of significant deficiency is not defined and confuses the definition of the threshold at which auditors must declare that such a problem exists.

Proposed Rule:

- Paragraph 8 -- A *significant deficiency* is an internal control deficiency that adversely affects the company's ability to initiate, record, process, or report external financial data reliably in accordance with generally accepted accounting principles. A significant deficiency could be a single deficiency, or a combination of deficiencies, that results in more than a remote likelihood that a misstatement of the annual or interim financial statements that is more than inconsequential in amount will not be prevented or detected.

- Paragraph 9 -- A *material weakness* is a significant deficiency that, by itself, or in combination with other significant deficiencies, results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

<u>Suggested Revised Rule</u>:

- "Significant deficiency" *is a single deficiency, or a combination of deficiencies in the same or closely related reporting area, that results in a reasonable possibility that a misstatement of the annual or interim financial statements* in an amount that is *more than de minimis but less than material will not be prevented or detected*." **OR** the term as currently used by the AICPA.

- "Material weakness" *is a significant deficiency that, by itself, or in combination with other significant deficiencies in the same or a closely related reporting area, results in a reasonable possibility that a material misstatement of the annual or interim financial statements will not be prevented or detected*."

These revised definitions have higher thresholds using terms with which accountants already have experience and extensive accounting literature and guidance. We believe the higher thresholds are more likely to provide practical warning flags rather than extensive laundry lists of false negatives.

3. <u>External Auditors Should Be Able to Use the Work of Others At the External Auditors' Discretion.</u>

Question 12-15: To what extent should the auditor be permitted or required to use the work of management and others? Are the three categories of controls and the extent to which the auditor may rely on the work of others appropriately defined? 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? 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)?

The proposal specifies certain procedures that must be performed by the auditor such as mandatory requirements for the external auditor to retest internal controls over other controls as well as those over fraud. We believe this rule should be rewritten to allow the auditors to exercise discretion on the extent of review required and the frequency with which these reviews must occur (for example, if a review was done in a prior year, we do not believe it necessarily, under all circumstances and for all issuers, needs to be completely redone in subsequent years). We believe the PCAOB should also recognize that unnecessary retesting by auditors can result in interruption of the operations and financial reporting processes of companies.

In being so prescriptive, the PCAOB proposal risks undermining the role of an internal audit entirely, or, in the case of a smaller company, creating a financially unsupportable situation for the simultaneous presence of both internal and external oversight structures. The rules should make clear that the auditors should be free to exercise their reasonable professional judgment on the appropriate reliance level on internal work, including the work of internal auditors.

If the testing of the controls listed in Paragraph 104 of the proposal becomes mandatory for an outside auditor, management's incentives could shift from ensuring that their own internal auditors properly test the design and operation of these controls, at a high cost, to limiting the internal audit function involvement in such testing, thereby encouraging companies to cut costs in areas which will be retested by external auditors rather than paying twice for the same services. This will have the effect of undermining the role of the internal auditors.

We believe the three-tiered categorization of where to retest certain internal controls is too rigid and precludes auditors from exercising professional judgment. Why is it more important for an outside auditor to retest internal controls designed to prevent fraud on nonroutine transaction errors instead of testing those controls over routine transactions? We do not believe in a blanket rule that implies the existence of a hierarchy between transactions within a system of internal controls. The professional judgment of auditors should not be hindered or superceded in this rigid manner.

Proposed Rule:

- Paragraph 104 -- "There are a number of areas in which the auditor should not use the results of testing performed by management and others, including: (list of certain tests)"

- Paragraph 105 -- "The auditor's use of the results of procedures performed by management and others should be limited in the following areas: (list of certain tests)"

- Paragraph 106 -- "The auditor might decide to use the results of tests performed by management and others within the company in other areas, such as controls over routine processing of significant accounts and disclosures, without specific limitations."

Suggested Revised Rule: We respectfully submit that Paragraphs 104-106 be omitted and that the PCAOB rely solely on Paragraph 103 as proposed:

"The auditor should evaluate whether to rely on the work performed by management and others. When evaluating whether to use the results of procedures performed by others, the auditor should evaluate the following factors:

- The materiality or the risk of misstatement of the accounts and disclosures that the controls address.
- The degree of judgment required to evaluate the operating effectiveness of the control.
- The degree the control can be subjected to objective testing vs. a subjective evaluation.
- The pervasiveness of the control.
- The level of judgment or estimation that is required in the account or disclosure."

4. <u>Evaluating Audit Committee Oversight Should be Significantly Reduced and the Proposal Requiring the Auditors to Evaluate Audit Committees Should be Dropped.</u>

Questions 22-23: 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? Will auditors be able to effectively carry out their responsibility to evaluate the effectiveness of the audit committee's oversight?

Audit committees retain, supervise, compensate and fire auditors, as directed by Sarbanes-Oxley and the rules of securities exchanges and self-regulatory organizations. We respectfully believe, therefore, that the auditors should not be required to test the "effectiveness" of the audit committee. Effectiveness is not defined - does it mean failure to recognize issues, ability to recognize issues but failure to adequately address them, or something entirely different?

The proposal would require the auditor to evaluate the effectiveness of the audit committee's oversight of external financial reporting and internal control. Included in this evaluation are factors such as independence from management, clarity of the committee's responsibilities, level of involvement and interaction with the auditor and internal audit, including the committee's role in appointment and compensation of the auditor and internal audit, presence of an audit committee financial expert, compliance with applicable listing standards, the amount of time the committee devotes to control issues, and the amount of time committee members are able to devote to committee activities. This would require a much greater degree of involvement by the auditors in the internal operation of the audit committee and require observation of the work of the audit committee and the individual members as well as their interaction with third parties, such as internal audit. This would require skills that are beyond the expertise of auditors (such as knowledge of listing standards and interpretations). It would also interfere with the allocation of responsibility to the audit committee by state corporation law and by Sarbanes-Oxley.

In particular, the proposed standard requires the auditor to determine independence in the selection of candidates for the audit committee. This raises many issues of whether an auditor is qualified and able to make the subjective and perhaps legal determinations required by the proposal. It also presents conflicts since the auditors are to report to and be compensated by the audit committee. Can they be realistically requested to objectively make the enumerated determinations? Or does this present such a fundamental conflict of interest that it should not be required? We believe auditors currently view the audit committee as an important part of the financial integrity of a company and its internal control, but the key consideration for them is whether they have adequate access to and reaction from the audit committee rather than whether the audit committee is acting as a monitor.

Proposed Rule: Paragraph 58 -- "As part of evaluating the independence of committee members, the auditor should evaluate how audit committee members are nominated and selected and whether they act independently from management. Generally, the more independence that is built into the process of nominating members of the audit committee to the board, the more the auditor can be assured of committee independence. For example, are qualified candidates identified by outsiders, such as an outside search firm or a nominating committee composed of outside directors, or does management pick 'friends?' Are board candidates for the audit committee selected based upon desired skill sets?"

Suggested Revised Rule: Delete the requirement.

In addition, auditors should not be in a position of undermining the current requirement that boards determine the qualifications of the audit committee Financial Expert ("ACFE"). Sarbanes-Oxley made this decision the responsibility of the Board of Directors; the PCAOB should not change that responsibility. The standards for determining an ACFE are prescribed by the SEC pursuant to statutory direction, as implemented by the SEC's rule, and the Board's determination of satisfying that standard, which is likely a legal interpretation, should not be challenged by the auditor if the Board has based its decision on the SEC's implementing regulation. Sarbanes-Oxley also made the audit committee financial expert not a requirement, but a disclosure item. The Board of a reporting company could conclude that finding a person meeting the rather restrictive qualifications of the SEC's rule was unnecessary because it has confidence in the expertise of the members of its audit committee. The PCAOB would change this dynamic with its proposal.

5. <u>Qualified Opinions Should be Allowed.</u>

Questions 25-26: 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? Are there circumstances where a qualified "except for" conclusion would be appropriate?

Under the proposal, if there are one or more material weaknesses, management would be precluded from concluding that internal control over financial reporting is effective. In these circumstances, the auditor is required to express an adverse opinion on the company's internal control over financial reporting in connection with the annual attestation report and would not be permitted to issue a qualified "except for" opinion. For the reasons specified below, we respectfully submit that qualified "except for" opinions might be appropriate under certain circumstances.

We believe that during any given year, a significant number of public companies have outstanding "material weakness" designations, and we believe that it almost invariably takes more than one quarter to rectify them. Because it is in everyone's interest, particularly investors', to have problems identified and remedied, detecting a material weakness should not so significantly penalize a company that no opinion can be issued, resulting in consequences far beyond the magnitude of the material weakness, such as limiting the company's access to the capital markets. This result would have an enormous chilling effect on identifying problems in the first place and on capital markets transactions.

<u>Proposed Rule</u>: Paragraph 162 -- "If there are significant deficiencies that, individually or in combination, result in one or more material weaknesses, management is precluded from concluding that internal control over financial reporting is effective. In these circumstances, the auditor must express an adverse opinion on the company's internal control over financial reporting."

<u>Suggested Revised Rule</u>: Paragraph 162 -- "If there are significant deficiencies that, individually or in combination, result in one or more material weaknesses, management *must consider the extent of one or more material weaknesses in* concluding that internal control over financial reporting is effective, *and must disclose the nature of the material weaknesses and the actions being taken to correct them, in all earnings releases and 1934 Act filings*. In these circumstances, the auditors *should exercise professional judgment in deciding whether the nature of the material weakness requires them to issue* an adverse opinion on the company's internal control over financial reporting."

We respectfully propose that the PCAOB alter the requirement to allow for judgment on the part of auditors in identifying material weaknesses and determining whether the material weaknesses are being corrected as quickly as possible before issuing an adverse opinion.

6. Small and Medium-Sized Issuers

Question 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 applaud the PCAOB for not having prescribed a single method for compliance by all types of companies. Particularly, we agree with the PCAOB's view that "the nature and extent of controls that are necessary depend, to a great extent, on the size and complexity of the company." We respectfully urge the PCAOB to extend this acceptance of subjective decision-making by the auditors to the overall proposal as we have outlined in this letter.

7. Effective Date Question and Degree of Quarterly Auditor Involvement

The proposed standard would require the auditor to make inquiries of management on a quarterly basis about significant changes in the design or operation of internal control over financial reporting as it relates to the preparation of annual as well as interim financial information and to assess whether significant changes in internal control over financial reporting may have resulted in significant deficiencies or material weaknesses. Depending upon management's response, the auditor would be required to take additional action, ranging from communicating with the audit committee to reach an appropriate resolution to considering resigning from the engagement. Any communications of significant deficiencies or material weaknesses by the auditor may have an impact on and will need to be considered by management in making its Section 302 certifications and the company's disclosures under Item 308 of Regulation S-K. The effective date of the proposal, however, looks only to the 404 audit. We believe that the effective date of the proposal should be clarified to indicate that the 302 certification process with respect to matters covered in the proposal will not become effective until the respective 404 effective date.

The proposed standard would require an auditor to make certain determinations, "through a combination of observation and inquiry" as to whether significant changes in internal control over financial reporting have occurred during the quarter. We request the PCAOB to clarify that these determinations can be accomplished in connection with the current usual level of quarterly auditor involvement and will not require continuous observation by the auditor during the quarter.

Conclusion

We commend the PCAOB for proposing new standards of audits for internal controls over financial reporting. It is the belief of the Committee that the public would be well served if the PCAOB gave additional consideration to specific elements of the proposed rule, as set forth in this letter.

Please note that Committee member Wayne Carlin of the United States Securities and Exchange Commission did not participate in the preparation of this letter or the vote by the Committee to submit this letter to the PCAOB. In addition, this letter does not necessarily reflect the individual views of members of the Committee.

Members of the Committee would be pleased to answer any questions you might have regarding our comments, and to meet with the Staff if that would assist the PCAOB's efforts.

Respectfully Submitted,

/s/ N. Adele Hogan
N. Adele Hogan, Chair of Committee on Financial Reporting

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