Texas Society of
Certified Public Accountants

November 21, 2003

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

RE: 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.

To Whom it May Concern:

One of the expressed goals of the Texas Society of Certified Public Accountants (TSCPA) is to speak on behalf of its membership when such action is in the best interest of its members and serves the cause of certified public accountants in Texas, as well as the public interest. TSCPA has established the Professional Standards Committee to represent those interests on accounting and auditing issues. This communication is in accordance with that goal.

Our response to this Proposed Auditing Standard includes our answers to the questions posed in the document along with additional comments on issues we considered critical to the final draft of this Standard.

Our Committee believes this Standard will have a significant impact on the audit landscape. We believe there will be a need for auditors to adjust their approach to an audit engagement in light of the requirement to attest to the effectiveness of internal control. This Standard will certainly impact the evidence gathering process and techniques currently used in performing an audit engagement. We believe this Standard will dramatically increase the cost of an audit engagement as well as the time needed to complete the audit process. This Standard will mark the beginning of the "dual standards" for the performance of audit engagements. We believe the PCAOB should be cognizant of the potential for the "cascade effect" of its Standards on the audits of nonpublic companies. Such an event could have a devastating effect on nonpublic companies and many of the firms that perform their audits.

Comments on Questions Regarding the Proposed Standard

Question 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?

TSCPA Response: We do not believe it would be appropriate to refer to the auditor's attestation of management's assessment of the effectiveness of internal control as the audit of internal control over financial reporting. An audit, by definition, implies an examination of underlying data. Unless an auditor performs audit tests, he/she cannot indicate that an audit was performed. An auditor's attestation of management's assessment of the effectiveness of internal control does not, in our opinion, constitute an audit. Additionally, management is not required to perform tests to determine the effectiveness of internal control. Management is only required to provide an assessment. Management can use any number of techniques to make the assessment, and testing may or may not be among them.

Question 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?

TSCPA Response: We do not believe an auditor should be prohibited from performing an audit of internal control without performing an audit of the financial statements. In the unlikely event that there is a concern over the objectivity of the auditor performing both the financial statement audit and the audit of internal control, then there should be two separate auditors. Certainly, from an efficiency and effectiveness point of view, having the same auditor (audit firm) conduct both audits would be preferable. However, we don't think it would be prudent to require that both audits could only be performed by the same auditor.

Question 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?

TSCPA Response: We believe requiring the auditor to perform work with regard to the financial statements *comparable* to that required to complete the financial statement audit to be a requirement that appears to narrowly dictate the scope of the audit of internal control. Also, isn't "the performance of work *comparable* to that required to complete the financial statement audit," essentially auditing the financial statements? We obviously don't see this as an appropriate alternative.

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 companies?

TSCPA Response: We believe this Standard is aimed at the large publicly traded companies where internal controls can be implemented in a more cost-effective manner than is possible in small and medium-sized companies. The requirements of this standard impose a substantial cost impact on small and medium-sized companies. Recent reports in the financial press regarding relatively small public companies being taken private as a result of the requirements of the Sarbanes-Oxley Act indicate a significant concern about the cost of compliance.

Question 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.

TSCPA Response: There is no question that the Board should specify the level of competence and training of the audit personnel that is necessary to perform auditing procedures effectively. Lack of experience on the part of audit staff personnel is one of the primary factors cited in many of the recent audit failures. These personnel are performing a significant amount of the audit work without effective supervision. We believe internal control represents one of the most subjective aspects of a client's accounting system. To allow the responsibility for the assessment of internal control to be put primarily in the hands of inexperience personnel seems contrary to the intent of the Proposed Standard. The Board should definitely specify the level of experience necessary to be a part of the audit team evaluating the client's assertion about the effectiveness of its internal control.

Question 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?

TSCPA Response: We believe the scope of the audit is appropriate assuming that the auditor performing the audit of the financial statements also performs the internal control audit. If the auditor performing the audit of the financial statements is different from the auditor performing the internal control audit, then issues related to the scope of the audit of internal control should be addressed in the Standard. However, as mentioned earlier, we do not believe the scope of the internal control audit should include "work *comparable* to that required to complete the financial statement audit."

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

TSCPA Response: We believe the Board should provide criteria that auditors can use in evaluating the adequacy of management's documentation. An auditor needs to be provided with guidelines that he/she can use in assessing management's documentation. Without such guidelines the audits of internal control performed by public accounting firms would lack comparability and users would be uncertain as to the basis for the auditor's conclusions.

Question 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?

TSCPA Response: Given the fact that documentation is a necessary part of management's assessment of internal control effectiveness, we believe inadequate documentation of internal control would constitute an internal control deficiency. However, we do not necessarily believe that inadequate documentation of internal control should automatically be considered a significant deficiency or material weakness in internal control. The auditor should be cautioned in the Standard to consider whether such inadequate documentation may indicate a significant deficiency or material weakness in internal control.

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

TSCPA Response: We believe walkthroughs enhance the auditor's level of understanding and should be required. However, it should be pointed out in the Standard that walkthroughs are a necessary, but not sufficient, condition for an auditor's understanding of internal control. An auditor should be required to perform whatever tests/procedures he/she considers necessary in the circumstances.

Question 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?

TSCPA Response: In addition to our belief that a walkthrough should be required, we feel the walkthrough should be conducted by the external auditor. However, this should not preclude the external auditor from placing reliance on the work performed by an internal audit staff in situations where he/she has determined that the client has a strong, effective internal audit function. The criteria established for assessing the effectiveness of the internal audit function in SAS 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, should be used.

Question 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?

TSCPA Response: We believe it would be appropriate to require the auditor to obtain evidence of the effectiveness of internal controls for all relevant assertions for all significant accounts and disclosures every year if problems continue to exist in the effectiveness of the client's internal controls. However, in situations where the auditor's testing showed strong, effective internal controls, the auditor should not be required to perform tests on an annual basis. Thus, we believe that annual testing should only be required if the auditor encounters problems in his walkthrough and general assessment of internal controls. Additionally, yearly testing might be required in situations where the auditor considers the risk of material misstatement due to fraud to be high.

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

TSCPA Response: In our opinion, the extent to which the auditor should be allowed to use the work of management and others should be limited to the work performed by the internal audit staff. This, of course, assumes that the auditor has determined through assessment of the internal audit function that its work is competent and objective (SAS 65).

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

TSCPA Response: The three categories appear to be appropriately defined.

Question 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?

TSCPA Response: We believe that the Proposed Standard is lacking in its recognition of the work of internal auditors. A competent and objectively placed internal audit function can provide the external auditor with a great deal of assistance in accomplishing the objectives of this Standard. If reliance is based on an assessment of the competence and objectivity of the internal audit function (SAS 65) the external auditor should have a strong basis for placing reliance on the work of the internal auditor.

Question 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)?

TSCPA Response: An auditor should be required to reperform the work of others that he/she plans to rely upon until the auditor feels that the work being performed by others meets an appropriate level of quality and reliability. Subsequent to the decision to rely on the work of others, the auditor should exercise professional judgment in determining when subsequent reperformance of such others' work should again be considered.

Question 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?

TSCPA Response: An auditor's comfort and reliability level concerning a client's internal control should grow over time. Initially, it would appear that the auditor should have to obtain the principle evidence, on an overall basis, through his/her own work. The auditor should always be required to perform some first hand analysis of internal control. Thus, the Standard should not imply that the auditor can ever rely solely on the work of others in reporting on management's assertion about internal control effectiveness.

Question 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?

TSCPA Response: We believe the definitions appear to be adequate at this time. However, we suggest that the Board closely monitor this area of practice and changes in business environments in an effort to maintain the relevance of the definitions of significant deficiencies and material weaknesses.

Question 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?

TSCPA Response: The examples in Appendix D provide helpful guidance. We are reluctant to provide any additional examples due to the new ground that this Standard covers. However, we believe that once the Standard is implemented and practitioners are involved in the process, a number of specific questions will be raised. At that time the development of more timely and relevant guidance will be possible.

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

TSCPA Response: We believe that the evaluation of the severity of all identified deficiencies should be required. Without an evaluation of the severity of all deficiencies, an auditor might not adequately assess a deficiency that could permit a material misstatement to occur.

Question 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?

TSCPA Response: It is important that auditors be required to communicate, in writing, all internal control deficiencies to management. Such communication is necessary in assisting the client in deciding whether the deficiency is of a nature that corrective action should be taken.

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

TSCPA Response: We believe the matters are appropriately classified.

Question 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?

TSCPA Response: We believe the external auditor is appropriately placed to provide an evaluation of the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting. The fact that the audit committee is responsible for the appointment of the external auditor may be seen by some as a deterrent to an objective assessment by the auditor. However, we believe an ineffective audit committee could cause significant problems with which an auditor would not want to be associated.

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

TSCPA Response: We fully believe an auditor should be able to effectively carry out his/her responsibility to evaluate the effectiveness of the audit committee's oversight responsibility. An auditor's inability to make this evaluation would most likely be caused by a limitation of the auditor's scope by the client. This kind of action would most likely indicate to the auditor that there is a problem with the oversight function.

Question 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?

TSCPA Response: Guidance should be provided to an auditor concerning when he/she should give serious consideration to withdrawing from an engagement. It would be quite difficult to provide examples of every scenario that would require the auditor to withdraw from an engagement. There are so many variables that could be involved in such a situation that we believe ultimate withdrawal should be left to the auditor's professional judgment.

Question 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?

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

TSCPA Response to Questions 25 and 26: We do not believe the existence of a material weakness, by itself, should require the expression of an adverse opinion. We do believe that such a circumstance should, as a minimum, result in a qualified "except for" opinion. The issuance of an adverse opinion should be left to the judgment of the auditor. Setting a requirement that an adverse opinion must be issued when a material weakness exists, results in treating all material weaknesses the same. We believe that material weaknesses can vary in degree of the significance regarding a particular entity's internal control. Thus, the auditor should be able to assess the impact of the material weakness on the client in deciding on the type of opinion to issue.

Question 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?

TSCPA Response: When an auditor issues a non-standard opinion on the effectiveness of an entity's internal control, the reasons for the departure should be stated in an explanatory paragraph(s) in the report.

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

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

TSCPA Response to Questions 28 and 29: We fully believe the Board should provide specific guidance on independence and internal control-related non-audit services in the context of the Proposed Standard. While it might appear appropriate to prohibit the financial statement/internal control auditor from providing internal control-related non-audit services, we believe that such a requirement would be counterproductive. The auditor who performs the internal control audit is in the best position to know where the deficiencies are and what needs to be done to correct those deficiencies. Therefore, we believe it would not be an impairment of the auditor's independence for him/her to provide consulting services to the client so that the client's internal control can be brought into compliance with the requirements of this Standard.

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

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

TSCPA Response to Questions 30 and 31: We find no problems with the differing levels of responsibility regarding certification or the auditor's responsibility for quarterly disclosures.

Thank you very much for allowing us the opportunity to present these comments in accordance with the goals stated above.

Sincerely,

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