

PIERCY BOWLER TAYLOR & KERN

Certified Public Accountants • Business Advisors

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:

We appreciate the opportunity to comment upon the proposed auditing standard contained in Release No. 2003-107 with regard to the independent auditors' responsibilities under Sec. 404 of the Sarbanes-Oxley Act of 2002 and related regulations. The proposed standard apparently represents the result of substantial analysis and consideration of many issues concerning auditors responsibilities and users' needs in this newly expanded area of financial reporting and the attest function.

Because of the comprehensiveness and sheer volume of the proposed standard and the relatively short comment period, rather than directly addressing the 31 questions posed by the Board in its 25-page letter accompanying the draft standard (which we will leave to other commentators with greater resources), we will necessarily limit our comments to those few matters we believe to represent significant inherent inconsistencies or potential conflicts in, or likely to be caused by, the standard, if adopted as proposed, and other issues most seriously, in our opinion, in need of reconsideration by the Board.

The principal inconsistency we see in the proposed standard relates to the long-accepted premise underlying the definition of *internal control over financial reporting* set forth in paragraph 6, and virtually all other similar definitions that have appeared in our authoritative literature throughout the institutional history of the auditing profession. That is, that internal control can only provide reasonable, but not absolute, assurance of achieving its objective of preventing or detecting misstatements or misappropriations of resources. The notion of reasonable, but not absolute, assurance, effectively acknowledges that misstatements and misappropriations (which could be material) can occur even in the presence of the strongest, most effective controls as a result of innocent human failures (for example, inadvertent errors, oversight or poor judgment) or collusion or management override. But in the face of these acknowledged facts of business life, the standard seems to abandon the notion of "reasonable assurance" by prejudging in paragraph 126 that the discovery of a material misstatement in the financial statements by the auditors must be reported at least as a significant deficiency and establishing an effective burden of justification if it is not reported as a material weakness. The same is true with regard to restatements of previously issued financial statements.

By prejudging the reporting implications of such events with respect to internal control reporting, the standard not only eliminates both the opportunity and obligation to exercise sound professional judgment based on facts and circumstances, but creates enormous potential for disagreement between management and the auditors (which disagreement would be separately reportable also under other provisions of the securities laws and regulations). We believe such unequivocal prejudgment at the standard level would likely cause a large number of smaller issuers to receive qualified or adverse opinions on internal control, for no reason other than the fact that the company's auditors are doing a good job in finding and proposing adjustments, thus severely impairing their future access to the capital markets and causing diminution in the value of the public shareholders' investments, event if the financial statements contained no material misstatements when issued. We do not believe this kind of reporting would be in the investing public's best interests.

We also believe that the definition of *internal control deficiency* in paragraph 7 should be revised to more closely mirror the definition of *internal control over financial reporting* in paragraph 6 by incorporating a reference to the notion of reasonable assurance. For example, the definition might be modified as marked in boldface type below:

“An *internal control deficiency* exists when the design or operation of a control does not **allow reasonably assure that** management or employees, in the normal course of performing their assigned functions, **to will** prevent or detect misstatements on a timely basis.”

Additionally, since they are the bodies most responsible for overseeing both management and the independent auditors, we regret that Sarbanes-Oxley did not place any regulatory oversight on audit committees, as it did for auditors by establishing the Board. But we believe any attempt (as in paragraph 126) to repair that omission by making auditors responsible to report publicly on the performance of the audit committees, sets up a serious conflict of interest for auditors since audit committees are responsible for their selection (hiring and firing) and performance evaluation. This kind of circular oversight would be, in our view, untenable in many likely circumstances.

Recognizing, as mentioned above (in the third paragraph of this letter) that, given the principle of reasonable assurance, even under the best controls, material misstatements can nevertheless occur for a variety of reasons, we have been concerned since Sarbanes-Oxley was finalized in 2002 that publicly distributed auditors' unqualified opinions on the effectiveness of internal controls (or the fairness of management's positive assessment) may lull investors into a false sense of security about the likelihood of a misstatement, particularly, those users who might tend to “zero in” on the opinion paragraph without reading the “inherent limitations paragraph” (as it is referred to in APPENDIX A) that precedes it in the illustrations. We suspect this concern contributed significantly to the failure of prior attempts by the SEC in 1979 and 1988 to require audit reports on internal control in public filings. We believe that our concern could be ameliorated by moving the language illustrated in the inherent limitations paragraph to the end of the opinion paragraph and connecting it with a transitional word such as “however.” This would be more effective, we believe, in placing the unqualified opinion in proper perspective.

We hope we have clearly articulated our significant concerns about the proposed standard for your consideration. However, if there are any questions, please contact either of the undersigned.

PIERCY, BOWLER, TAYLOR & KERN



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