Goldman Sachs

November 21, 2003

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

Re: PCAOB 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

Goldman, Sachs & Co. strongly supports the Public Company Accounting Oversight Board ("the Board") in its mission to oversee the auditing of public companies and to protect the interests of investors, specifically in the preparation of informative, accurate, and independent audit reports. Therefore, we appreciate the opportunity to comment on the above-referenced standard.

In general, we support the Board's proposal and believe that it will significantly enhance the value of an auditor's opinion on financial statements. And, while we are concerned about the additional costs and burden of work that will be placed on issuers, we acknowledge the need for a more meaningful and effective process for overseeing internal controls and we recognize that this cannot be achieved without additional expense. We do, however, have some comments and concerns that we hope will be helpful to the Board; they are noted in the attachment to this letter.

Once again, we appreciate the opportunity to offer our views and we would be happy to meet with you to discuss them.

Sincerely,

/s/ Sarah E. Smith

Sarah E. Smith
Chief Accounting Officer
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ATTACHMENT: Comments and Concerns

Creation of an Appropriate Environment

Paragraph 150 precludes management from concluding that a company's internal controls over financial reporting are effective if a single instance of a material weakness is identified, material weakness defined as *more than remote likelihood* that a *material misstatement* will not be prevented. Our concern is that the proposal sets too low a trigger event for an outcome that could have very serious financial and reputational consequences for an issuer. And, when the "sufficiently in advance of the as of date" remediation requirement is considered, we believe there is substantial risk that an open and communicative environment for the purposes of identifying and deliberating internal control issues may not be fully realized.

Further, the auditor is required to report in writing all "significant deficiencies" to the audit committee. A "significant deficiency" is defined as a single deficiency or a combination of deficiencies, that results in a *more than remote likelihood* that a misstatement of the annual or interim financial statements *that is more than inconsequential* in amount would not be prevented or detected. We believe that for a large, complex, global organization, to set the levels at "more than remote" and "more than inconsequential" is likely to generate a multitude of marginal items, diluting the audit committee's ability to focus on issues material to the financial statements.

Accordingly, we would offer the following comments and suggestions:

> Definition of "Significant Deficiency" and "Material Weakness"
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> A significant deficiency should be defined as a deficiency that results in a *reasonable possibility* that a *material* misstatement in the financial statements would not be prevented. Under this definition, the audit committee would be alerted to critical control issues requiring their immediate focus and attention. Material weakness should be re-defined as a deficiency that results in a *probable* likelihood that a *material* misstatement in the financial statements would not be prevented. We believe this would ensure that both management and the auditor would properly and quickly focus on those issues that could lead to a material misstatement of the financial statements.
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> Remediation Period
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> Paragraph 151 would prohibit management from concluding that controls were free of material weakness if a material weakness was identified in the fourth quarter and yet was not remediated "sufficiently in advance of the as of date." Further, this situation would trigger an adverse (or scope limitation) opinion by the auditor. We believe this requirement does not credit management with best efforts where a material weakness is discovered and acted upon immediately, including execution of an appropriate remediation plan. Under the proposal, in that situation the opinion would still be adverse, simply because remediation wasn't completed "sufficiently in advance of the as of date." We have similar concerns over the subsequent event period. Management during the period-end close may detect an issue, adjust the financial statements accordingly, implement

and complete a remediation plan, all prior to the release of the year-end financial statements, yet still receive an adverse opinion because of the "sufficiently in advance of the as of date" requirement.

At the same time, the Board refers to the audit of internal controls and the audit of the financial statements as an integrated audit resulting in two opinions. During a financial statement audit, the auditor may propose adjustments to the financial statements, and management is accorded the opportunity to adjust the financial statements, and receive an unqualified opinion. If the audit of internal controls over financial reporting performed in conjunction with an audit of financial statements is structured as a single engagement, and we agree with the Board that it should be, we would propose that management have the same opportunity to correct any internal control weaknesses, and still receive an unqualified opinion. In paragraph 95, the Board acknowledges that certain controls are performed after the "as of date," and it requires the auditor to test those controls and include them in the "as of date" opinion. We propose that actions taken by management during this period should be treated identically, with the ability to remediate any weaknesses discovered during the period-end close, up to and including the date on which the audit opinion is rendered. We believe this will foster an open and communicative environment in which management and the auditor are eager to both identify problems and remediate them whenever they are identified.

<u>Material Misstatements Identified by Auditors</u>
Paragraph 126 lists examples that would be regarded as significant deficiencies and strong indicators of material weaknesses. One such example is a material misstatement in the financial statements in the current period identified *by the auditor* prior to the company's internal control structure identifying the issue. We believe there are situations where a breakdown in an internal control that could lead to a potential misstatement in the financial statements would be effectively detected and resolved by management's period-end control procedures. Yet, under the proposal, if the auditor were to identify the issue first[1], it would trigger a strong indicator that a material weakness exists. In this situation, it seems to us unduly harsh that management not receive credit for the full range of controls in place that would have identified the error, simply because the auditor identified the issue prior to management. Accordingly, we would suggest that when a material misstatement is found by the auditor, the auditor should conduct an immediate assessment of the downstream controls, and only in the event that the auditor were to determine these to be ineffective would a material weakness be deemed to exist.

In summary, we believe the suggestions outlined above would significantly improve the likelihood that an appropriate environment would be created by which the Board would achieve

[1] Typically the auditor would begin their fieldwork simultaneously with the period-end close.

its objective of enhancing the quality of audits and of ensuring the swift identification and remediation of control issues.

Reliance on the Work of Others
Paragraphs 103 through 110 limit the extent to which the auditor can rely on work performed by others. The proposal states that (i) an auditor cannot place any reliance on work performed by others in the areas of fraud controls, period-end financial reporting controls, certain general information technology controls, or walkthroughs; (ii) limited reliance can be placed in the area of non-routine, judgmental transactions or areas where the risk of failure of the control to operate effectively is deemed to be high; and (iii) wider reliance may be placed by the auditor on work performed by others involving routine transactions.

While we fully agree that the auditor must gather the “principal evidence” to support the audit opinion, and that reliance by the auditor on the company for the review of required period-end financial reporting controls or for performing walkthroughs should be prohibited, we think that giving prescriptive rules to the auditor in the other areas referenced would not be optimal. In these other areas, an auditor should be allowed to exercise judgment as to the level of reliance that can be placed on management and its control structure for the purposes of testing operational effectiveness of internal controls, as we believe this will provide incentive to companies to establish and maintain a robust system of internal controls.

Accordingly, we would propose that the auditor perform a full assessment of the control environment and “tone at the top” before determining the scope of the audit work. This assessment would include the audit committee, internal audit and other control areas such as controllers, which compose the organization’s financial reporting oversight. If such an assessment revealed a relatively weak control environment, we would expect auditors to question even the extent to which they could rely on the company’s work involving routine transactions. Conversely, a strong control environment would indicate that more reliance could be placed on work performed by others.

Assessment of the Audit Committee
Paragraphs 56 through 59 and Paragraph 126 discuss the inclusion of the audit committee in the scope of the audit opinion. While we agree that an ineffective audit committee represents a deficiency in the control environment, we are troubled by the inherent conflict of interest present in requiring the auditor to give an opinion on the committee that is directly responsible for his or her appointment, retention and compensation. Further, if such a review is included in the audit opinion, management would be required formally to evaluate the audit committee, notwithstanding its own reporting relationship to the committee. Alternatively, we would propose that the auditor perform a review of the effectiveness of the audit committee, not as part of the audit opinion, but rather as an integral part of the overall assessment of the company’s financial reporting oversight when determining the scope of the audit work to be performed and the extent to which the auditor may rely on the work of others. Accordingly, we believe that this assessment should replace the specific inclusion of the audit committee in the scope of the audit opinion.

Assessment of the Compliance Department
Paragraph 126 of the proposal states an ineffective compliance department in a highly regulated industry would be considered a significant deficiency, which implies that the compliance department would be included within the scope of the audit opinion. While we agree that such ineffectiveness would be at least a significant deficiency, the specific inclusion of compliance seems to us inconsistent with the direction provided by Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, which specifically limited scope to internal controls over financial reporting (and not to regulatory or compliance issues)[2]. Furthermore, the expanded scope appears to establish a higher standard for particular industries, and we do not believe industry specific requirements were intended by the proposal.

In contrast, we would again propose that the compliance department, and other areas within a company that are an integral part of the control infrastructure, should be considered in a broad assessment of the control environment. Ineffectiveness of such areas should be considered by the auditor in determining the scope of work and the extent to which reliance can be placed on the work of others. Accordingly, we believe that this assessment should replace the specific inclusion of the compliance department in the scope of the audit opinion.

Walkthroughs
Paragraphs 79 through 83 require the auditor to perform "walkthroughs." In a walkthrough of significant business processes, the auditor traces all types of transactions and events, both recurring and unusual, from origination through the company's information systems until they are reflected in the company's financial reports. We believe this is an excellent proposal, and that walkthroughs confirm an auditor's understanding of the flow of transactions, the nature of the business, the design of internal controls, and the interrelationship of controls to processes. We believe this is a welcome return to basic audit techniques and that the auditor should be required to perform the walkthrough directly rather than rely on the work of others.

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[2] Section 404 scope has been consistently bounded with a focus on financial reporting; e.g., the proposal defines safeguarding of assets in Appendix C within the context of financial reporting.