November 21, 2003

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

RE: Rulemaking Docket Matter No. 008 (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

Dear Board Members:

The Audit and Assurance Services Committee of the Illinois CPA Society is a voluntary group of CPAs from public practice, industry, education, and government. We take an active role in the standards setting process and have spent considerable time over the past few years responding to audit-related exposure drafts issued by the AICPA, the GAO, the SEC, and other professional organizations.

We welcome the opportunity to comment on the proposed auditing standards being considered by the PCAOB. Our comments represent the collective views of the Committee members and not the individual views of the members or the organizations with which they are affiliated. Our comments have been structured to respond to each of the questions asked as part of the exposure process. The organization and operating procedures of our Committee are outlined in Appendix A to this letter.

<u>QUESTIONS POSED BY THE PCAOB (in bold) and COMMITTEE RESPONSES</u>

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.

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?**

   While a single firm or auditor should be required to perform audits of internal controls and financial statements as of a balance sheet date, there should not be a prohibition on additional internal control audits performed at points other than the audited balance sheet date. The PCAOB may want to give companies the option of having additional audits of internal control over financial reporting performed at other points during the year. For companies requiring additional SEC oversight, interim audits of internal controls could become a valuable tool in preventing or detecting financial reporting problems. The financial statement auditors (or other audit firms) should not be prohibited from performing additional audits of internal controls.

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 noted in #2, we believe flexibility is critical to permit audits of internal controls at points other than the balance sheet date. In these cases, certain testing would be required to evaluate the adequacy of control systems and procedures. An internal control audit could determine that financial information was properly controlled and processed without determining that account balances were fairly presented for financial reporting purposes.

   In addition, the use of the term “complete” in the above question should be clarified. We assumed that the PCAOB did not mean that the auditor must complete the audit and issue a report. Auditors must always have the option of disclaiming an opinion or withdrawing from an engagement.

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 would agree that for small and mid-sized issuers, auditors should rely on their judgment in determining the nature, timing, and extent of audit procedures required to test internal controls. We believe it would be helpful if the PCAOB provided guidance about the minimum appropriate level of internal control related audit procedures for the smallest of issuers. Similarly, it would be helpful to specify the minimum acceptable level of controls documentation.

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.**

   While presenting guidance on any specialized training needed to ensure auditor competence might be beneficial, a general requirement that competent well-trained auditors perform all audit procedures would not seem necessary. Matters pertaining to fraud, material errors, irregularities, material weaknesses, disagreements with management, and scope limitations should be the responsibility of the most experienced auditors, generally, managers and partners.

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?**

   Yes.

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

   Yes. The criteria are appropriate in a broad sense, but there needs to be some corresponding documentation requirements for management to follow. Absent specific management documentation criteria, we believe there will be unacceptable disparity in the extent and quality of controls documentation since it will be based on each auditor's experience and preference.

In addition, paragraph 43 states that the auditor "should evaluate whether such documentation includes the following...". Was this intended to be an all-inclusive listing? Would the phrase "should include the following..." be more appropriate? In addition, we suggest the PCAOB consider how certain terms are being used. Some of the subjective wording such as "significant", "enough", and "material" could be viewed as either helpful if it allows an auditor to use judgment or vague if it leaves items open to interpretation.

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?**

   Due to vast differences in the size of companies and the lack of guidance for management to follow in documenting and evaluating internal controls, instances of inadequate documentation should be considered internal control deficiencies. These deficiencies should be subjected to further evaluation to determine their significance and whether they should be classified as a material weakness or significant deficiency. Auditors should be allowed to use judgment in determining the significance of any weakness or deficiency noted in an audit.

   In addition, the language included in the last sentence of paragraph 46 seems inappropriate and should be reviewed. Allowing management to demonstrate its monitoring of controls in the absence of documentation appears to contradict the intent and spirit of the proposed audit standard. It was unclear what PCAOB intended by this sentence. We recommend that this sentence be eliminated. Otherwise, additional guidance will be needed for auditors to follow when evaluating controls in the absence of documentation.

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

   Yes.

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?**

    No. While some walkthroughs should be performed by the auditors themselves, all auditors should also have the flexibility of using work performed by others. Before relying on any of this work, the financial auditors must satisfy themselves that the internal auditors (or others) were competent and independent. It is a rebuttable presumption that walkthroughs performed by management would not be considered independent and should not be relied upon.

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?**

    In the present day, auditing is often considered to be a continuous process. Where appropriate, auditors should be able to utilize evidence obtained during prior audits, but not rely solely on this evidence to draw conclusions. Audit workpapers should indicate how the auditors reassessed the quality and reliability of this evidence. We might draw too specific a distinction if auditors can use evidence on internal controls that is 11 months old, but not evidence that is 13 months old.

In addition, the PCAOB may want to establish some guidance on the rotation of audit procedures. While auditors must review all major systems every year, how much of the detail testing can be rotated on a multi-year audit engagement? Auditing all controls every year could become cost prohibitive in a large company. More importantly, where there has been no change in personnel, systems, or procedures, testing all controls annually may not be an efficient use of limited audit resources. Audit costs could be reduced by effectively using a rotating approach to controls testing. This rotation often leads to a more thorough examination of the areas selected for testing.

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

The auditor should be required to review reports issued by internal auditors, regulators, and other third parties to identify any internal control deficiencies that came to their attention. However, it should be left up to the auditor's discretion as to whether it would be efficient to test and rely upon this work.

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

No. Auditor judgment should be the prevailing factor in determining the extent to rely on work performed by others. We do not believe auditors should be limited in their use of work performed by internal auditors, regulators or other third parties. As part of every audit, the auditor should be solely responsible for determining whether reviewing and testing such work would be effective and efficient. However, because of management independence issues, auditors should not rely on work performed by management without adequate review and testing.

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?

Yes. The proposed standard gives appropriate recognition to the work of internal auditors. However, the standard does not provide sufficient guidance for determining whether to rely on internal audit work. The ability to rely on internal control reviews performed by internal auditors could become one of the major factors in controlling the costs associated with internal control audits. In many companies, the internal auditors are the entity’s experts on internal controls. The auditor should use this work to the extent appropriate and based on his or her judgment.

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)?

Yes, the flexibility is appropriate and necessary. The auditor should determine the extent of reperformance when they choose to rely upon work performed by others. We believe the standard should make it clear that some level of reperformance is always 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?

Yes, the auditor should obtain the principal evidence. It should be clear however, that this evidence may include the testing and reliance on the work of internal auditors, regulators and other third parties.

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?

Yes, we agree that the definitions provide needed clarity. One recommended improvement would be to define the term "inconsequential" (as used in Paragraph 3 of Example D-1). It was unclear whether the intent was to differentiate between "immaterial" and "inconsequential" weaknesses.

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?

Yes. As noted above, the term "inconsequential" should be defined.

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

Yes. All deficiencies noted during an audit of internal controls must be accumulated and evaluated to determine whether a material weakness or significant deficiency exists.

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?

No. The handling of clearly inconsequential deficiencies should be modified to allow for auditor judgment. During any testing of transactions, many minor deficiencies can be noted. Auditors must accumulate these deficiencies and perform an analysis to determine whether the inconsistencies noted were isolated occurrences or indicators of internal control weaknesses.

The value of a management letter may be diminished if the document is required to contain a large number of inconsequential control deficiencies. However, some audit clients may request that all deficiencies be reported to management so management can perform its own assessment of the weaknesses noted. Auditors should be given the option of presenting inconsequential deficiencies to management orally.

In addition, the PCAOB should clarify whether "management" as included in the above question includes the Board of Directors. The guidance should clarify whether the reporting of inconsequential matters must include the Board.

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

Yes.

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?

Our Committee was equally divided on this question. Half of the members agreed that the auditors should review the effectiveness of the Audit Committee oversight. This work would become part of the internal control evaluation. The effectiveness of Audit Committee oversight would be a major factor in determining the nature, timing and extent of testing.

Other Committee members felt strongly that the auditor would not be in a position to evaluate all aspects of Audit Committee effectiveness, including certain matters of a legal nature. Only the PCAOB would be able to review the effectiveness of public company Audit Committees.

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

No. Even those Committee members that support the PCAOB position in question 22 recognize that this would be a difficult task. Requiring that auditors evaluate Audit Committee effectiveness may sound like a good idea, but may not work in practice. Regardless of the standards in place, audit firms may be hesitant to criticize an Audit Committee. In addition, it may be difficult for financial auditors to determine whether the Audit Committee members met the legal and regulatory requirements for audit committee service in a publicly traded company.

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?

No. Withdrawing from engagements where there is an ineffective Audit Committee would only pass the problem along to another CPA firm. This action would do little to address any underlying problems. In most cases, issuing an adverse opinion to stockholders and investors should be more beneficial. However, auditors must be required to evaluate each case and determine whether to withdraw from the engagement. In situations where the Audit Committee does not possess the independence or the competence to perform effectively, the auditor may decide the risks are higher than acceptable and sever the audit relationship.

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?

Yes, the reporting requirements should be consistent. The auditor should not be permitted to issue a report that is more favorable than management's report.

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

No.

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?

Yes.

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

Yes. It would be helpful to have specific guidance to clarify permissible services. For example, guidance would be helpful to distinguish how the auditor can make substantive recommendations to management for improving the design of internal controls without these recommendations being classified as “design” work thereby impairing independence.

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

Yes. Based on the assumption that the PCAOB is not comfortable with the auditor becoming a participant in the process of designing internal controls over which he/she will issue an audit report, the standard should prohibit any role in the design, documentation, or implementation of internal controls. Any internal control related services performed by financial statement auditors could have independence implications.

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

Yes. The PCAOB has made a reasonable distinction between the auditor’s responsibilities for information in management’s quarterly versus management’s annual certifications.

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

Yes.

The members of the Audit and Assurance Services Committee of the Illinois CPA Society thank you for the opportunity to respond to this proposal.

Sincerely,

William P. Graf, Chair
Audit & Assurance Services Committee

Scott P. Bailey, Chair
Comment Letter Subcommittee

APPENDIX A

ILLINOIS CPA SOCIETY
AUDIT AND ASSSURANCE SERVICES COMMITTEE
ORGANIZATION AND OPERATING PROCEDURES
2003 - 2004

The Audit and Assurance Services Committee of the Illinois CPA Society (Committee) is composed of the following technically qualified, experienced members appointed from industry, education and public accounting. These members have Committee service ranging from newly appointed to more than 20 years. The Committee is an appointed senior technical committee of the Society and has been delegated the authority to issue written positions representing the Society on matters regarding the setting of auditing standards. The Committee's comments reflect solely the views of the Committee, and do not purport to represent the views of their business affiliations.

The Committee usually operates by assigning Subcommittees of its members to study and discuss fully exposure documents proposing additions to or revisions of auditing and attest standards. The Subcommittee ordinarily develops a proposed response that is considered, discussed and voted on by the full Committee. Support by the full Committee then results in the issuance of a formal response, which at times includes a minority viewpoint. Current members of the Committee and their business affiliations are as follows:

Public Accounting Firms:	
Large:	
Dolinar, James A. CPA	Crowe Chizek & Co. LLP
Gabouer, Kurt CPA	KPMG LLP
Graf, William P. CPA	Deloitte & Touche LLP
Graham, G. W., CPA	Grant Thornton LLP
McClanahan, James P. CPA	Altschuler, Melvoin & Glasser LLP
Pierce, Michael J. CPA	American Express Tax & Business Services
Waggoner, Joan, CPA	Blackman Kallick Bartelstein LLP
Medium: (more than 40 employees)	
Gregor, Sharon J. CPA	Selden, Fox and Associates, Ltd.
Mills, Gary W., CPA	KGN Financial Group LLC
Panfil, Stephen R. CPA	Bansley & Kiener LLP
Small: (less than 40 employees)	
Davila, Antonio Jr. CPA	Hill, Taylor LLC
Goltz, Jeffrey M. CPA	Rosen, Goltz & Associates
Kramer, Loren B. CPA	Kramer Consulting Services, Inc.
Krueger, Andrea L., CPA	Corbett, Duncan & Hubly P.C.
Lewis, Ludella, CPA	Ludella Lewis & Company
Malito, JoAnne M., CPA	McGreal, Johnson and McGrane
Owens, Robert W. CPA	Wermer, Rogers, Doran & Ruzon
Spiegel, Richard D., CPA	Steinberg Advisors, Ltd.
Industry:	
Hunt, Brian J. CPA, JD	Williams Montgomery & John, Ltd.
Adler, James R. CPA, CFE, PhD	Adler Consulting, Ltd.
Government:	
Bailey, Scott P. CPA	Metropolitan Pier & Exposition Authority
Educators:	
Petravick, Simon P. CPA	Bradley University
Whittington, Oliver R., CPA	DePaul University
Staff Representative:	
C. Patricia Mellican, CPA	Illinois CPA Society