American Society of Corporate Secretaries

November 21, 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**

Dear Board Members:

The American Society of Corporate Secretaries, Inc. ("Society") is a professional association founded in 1946, serving more than 4,000 corporate attorneys and other business executives who represent over 3,000 companies. The members' major duties include working with corporate boards of directors to improve corporate governance; assuring company compliance with securities regulations; coordinating activities of stockholders, including proxy voting for the annual meeting of shareholders; and administering other activities handled by the Corporate Secretary's Office. The majority of the Society's members are attorneys.

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements (the "Proposed Standard"). The Proposed Standard covers attestation engagements under Sections 404(b) and 103(a)(2)(A) of the Sarbanes-Oxley Act of 2002 (the "Act").

First, the Society would like to make general comments about its perception of the approach that the Proposed Standard seems to be taking. Then we would like to address selected topics of particular interest to our members: External auditors' oversight of the effectiveness of audit committees; communications among external auditors, management and the audit committee; the ability of external auditors to rely on the work of others, especially internal audit; the introduction of new terminology; and the characterization of the external auditors' attestation opinion.

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**<u>General</u>**

We applaud the PCAOB for being sensitive to the fact that internal control over financial reporting cannot be "one-size-fits-all." However, as a general comment, we would like to note that the Proposed Standard takes away much of the professional judgment and expertise that external auditors could bring to the assessment of internal controls over financial reporting in a

given factual situation. We recommend that the Board allow external auditors to exercise their judgment to a greater extent than currently contemplated under the Proposed Standard.

**Oversight of Effectiveness of Audit Committees**

Section 301 of the Act states that "[t]he audit committee . . . shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by the issuer . . . and each such registered public accounting firm shall report directly to the audit committee . . . ." Paragraphs 56-59 of the Proposed Standard require the external auditors to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting.

Conflict of Interest. We believe that Paragraphs 56 – 59 create an unworkable conflict of interest for the external auditors. Paragraph 59 of the Proposed Standard states that "[i]neffective oversight by the audit committee of the company's external financial reporting and internal control over financial reporting 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." Paragraph 57 states that the external auditor should evaluate the "Committee's compliance with applicable listing standards adopted pursuant to Section 301 of the Act." Major new laws, rules and standards have arisen from numerous regulatory fronts affecting both issuers and their external auditors. One of the audit committee's primary responsibilities is to retain, terminate and determine the compensation paid to external auditors. In its final listing standards' discussion on the role of audit committees, the New York Stock Exchange ("NYSE") states that one of the committee's purposes is to "assist board oversight of… the independent auditor's qualifications and independence. We believe this critical responsibility and oversight function of the audit committee is incompatible with, and would be compromised by, an evaluation of the audit committee by the external auditors under the Proposed Standard.

Scope of External Auditors' Evaluation. The Proposed Standard gives as examples seven factors that the external auditor should consider in evaluating the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting. With due deference to the professionalism and expertise of external auditors, some of the proposed factors venture into the realm of what the Securities and Exchange Commission (the "SEC") and the stock exchanges are addressing, not matters inherently within the expertise of external auditors. For instance, paragraph 58 of the Proposed Standard states that "[a]s 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 . . . For example, are qualified candidates identified by outsiders, such as an outside search firm or a nominating committee composed of outside directors, . . . ?"

We strongly recommend that the PCAOB defer to Section 303A.4(b) of the NYSE's final listing standards as approved by the SEC on November 4, 2003, which states that the nominating committee's purpose and responsibilities at a minimum must be to "identify individuals qualified to become board members, consistent with criteria approved by the board, and to select, or to recommend that the board select, the director nominees for the next annual meeting of shareholders . . . ." There are mechanisms to monitor and enforce the listing standards.

We note that, as a result of the Proposed Standard, external auditors are now planning significant audit procedures including lengthy surveys and interviews with audit committee members to fulfill this evaluation requirement. Given the existence of the NYSE listing standards addressing board and committee nominees and their independence, we believe that any added benefit of the external auditors also reviewing directors' independence would be immaterial and unnecessary, particularly when balanced against the significant added burden of the extra audit procedures.

## Communications

Paragraph 191 of the Proposed Standard requires the external auditor to communicate "to management, in writing, *all* [emphasis supplied] deficiencies in internal control over financial reporting (that is, those deficiencies in internal control over financial reporting that are of a lesser magnitude than significant deficiencies) identified during the audit . . . ." In addition, the external auditor must "inform the audit committee when such a communication has been made." This provision would require a change from external auditors' current practice of communicating significant deficiencies (reportable conditions) and material weaknesses in writing to the audit committee to an approach that would require communication to management of **all** deficiencies in internal controls over financial reporting identified during the audit and to inform the audit committee when a communication has been made.

The probable result is that most audit committees will feel that they cannot simply take on its face the fact that the external auditor reported deficiencies to management without exploring further. Instead, audit committees are likely to feel compelled to ask about the substance of all the deficiencies. What may then happen is that the committee will become bogged down in reviewing insignificant matters rather than focusing on topics of greater importance to the company and its owners. Accordingly, we recommend that the PCAOB retain the current reporting structure.

## Reliance on Work of Others, Especially Internal Audit

The Society appreciates the PCAOB's recognition of the expense and work incurred by companies: "[t]he more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be." It seems to recognize that the external auditor can rely on the work of internal audit in certain areas: "The proposed auditing standard . . . would allow the auditor to incorporate into the audit . . . some of the work performed by others, such as internal auditors or third parties . . . ."

However, other provisions limit the circumstances in which internal audit may be used. The draft proposes that internal audit *cannot* be used for the following areas:

- Control environment, including fraud controls.
- Controls over period-end financial reporting process.
- Controls that have a pervasive effect on the financial statements, such as certain IT general controls on which the operating effectiveness of other controls depend.

- Walkthroughs.

These prohibited functions are some of the key areas in which an internal audit group can provide significant insight and audit evidence based on its experience with the company. Public companies do not expect external auditors to rely solely on internal audit for 100% of testing. Eliminating internal audit from these critical areas, however, is a dramatic change from present accepted practices. In addition, this proposed point does not allow the external auditors latitude to use their own professional judgment. For example, in the new "walkthrough" concept that the Proposed Standard introduces, it is not clear if all processes in all locations (significant or otherwise) must have a walkthrough. Multinationals with complex global operations could have hundreds of processes located in numerous geographies involving multiple sites. We believe that external auditors should be allowed to use their judgment, taking into account the specific circumstances of the company, to determine the operating effectiveness of controls for all relevant assertions for all significant accounts and disclosures.

The proposed auditing standard also would require that, overall, the external auditor obtain directly the "principal evidence" about the effectiveness of internal control over financial reporting. It is our understanding that many external auditors are interpreting the Proposed Standard to mean that only they can provide the principal evidence. The result is significant increased costs to companies, without necessarily any more benefits going to the investing public. For all companies, small, mid-sized and large, the additional costs are likely to be very high. Anecdotally, our members report that their external auditors have told them to expect 25-100% fee hikes to cover internal control work.

Unfortunately, one unintended consequence if the Proposed Standard is adopted in this area will be to diminish or eliminate the role of internal audit. In its final listing standards, the NYSE reaffirmed the importance of internal audit by requiring that all listed companies have an internal audit function, a stance we urge the PCAOB to support. Effectively decimating strong internal audit functions will diminish, not enhance, the ability of corporations to maintain a strong control environment from which management can produce transparent financial statements with integrity that will inspire investor confidence.

**<u>Introduction of New and Broad Terminology</u>**

While we appreciate the Board's efforts to clarify the definition of "significant deficiency," which is not currently well defined in the auditing literature, we believe the Board's proposed definitions of both "significant deficiency" and "material weakness" capture an unnecessarily low and insignificant level of control deficiencies which were not within the intent of Congress when it adopted the Act. These new definitions also introduce significant ambiguities that make it difficult for companies or external auditors to interpret and apply the definitions. As an alternative to the Board's approach, we recommend the Proposed Standard give companies and the external auditors latitude to exercise judgment in determining those deficiencies that are significant enough to be elevated to management and the audit committee, or disclosed in public filings, while using more well-established terminology to provide definitional guidance. Rather than introducing the term "inconsequential" in the significant deficiency definition, we recommend that the Board use the well-understood concept of

materiality in addressing the magnitude of both a significant deficiency and a material weakness, and use different degrees of likelihood to distinguish between the two. Specifically, we recommend that the definitions hinge on whether there is a reasonable possibility that individual or aggregated deficiencies would lead to a material adjustment in the financial statements, in the case of significant deficiencies, and on whether it is reasonably likely the deficiencies would lead to a material adjustment in the financial statements, in the case of material weaknesses. Using terminology that is already well interpreted in the auditing literature, SEC guidance and judicial decisions will give companies and auditors greater ability to apply the definitions in exercising their judgment.

In addition, we ask that the Board avoid using terminology that appears to extend beyond the financial reporting controls scope of the SEC's rules. For instance, ineffective internal audit, risk assessment, and regulatory compliance functions are listed as examples of significant deficiencies. Yet in many companies, these functions extend beyond the realm of internal controls over financial reporting.

**Characterization of Qualified Attestation**

The Proposed Standard, in Paragraphs 177-179 discusses situations where there is an adverse opinion on the effectiveness of internal controls over financial reporting due to a material weakness but the auditor's opinion on the financial statements is unqualified because they were able to perform substantive procedures to satisfy themselves that there was no material misstatement in the financial statements. Paragraph 178 proposes the inclusion of qualifying language in the report on internal control over financial reporting explaining that the material weakness does not impact the audit report on financial statements. We are concerned that the appearance of an unqualified opinion on the financial statements alongside an *adverse* opinion on the effectiveness of internal control over financial reporting due to a material weakness that did not result in a material misstatement in the financial statements will create the perception to the investing public that the financial reports are unreliable despite the inclusion of the qualifying language in the report on internal control over financial reporting. We recommend that the external auditor be allowed to exercise judgment as to whether the opinion on the effectiveness of internal control over financial reporting should be regarded as a *qualified* opinion rather than an *adverse* opinion based upon the materiality of the weakness and scope limitations if any.

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The Society's members vigorously support the accountability of management for establishing and maintaining adequate internal controls over financial reporting. We hope that the Proposed Standard will permit companies and their owners to take full advantage of the professional and thorough work and expertise of management and internal audit. We also hope that external auditors are permitted to exercise their considerable professional expertise and judgment. If not, we risk violating the PCAOB's sensitivity that "internal control is not 'one-size-fits-all,' and the nature and extent of controls that are necessary depend, to a great extent, on the size and complexity of the company."

We appreciate your consideration of these comments. If you have any questions, please call me at 650-752-5339.

Cordially,

American Society of Corporate Secretaries

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Chair, PCAOB Subcommittee
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