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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 No. 008
Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

Dear Secretary:

Thank you for the opportunity to comment on the above referenced Proposed Auditing Standard (Proposed AS) which we believe represents an important step in promoting investor confidence through the effective assessment and reporting on internal controls over financial reporting. While we support your overall efforts concerning this very complex subject, we also appreciate the opportunity to comment on several important areas addressed in the Proposed AS. These areas include certain inconsistencies between the general framework and the Proposed AS, the testing of operational effectiveness, use of the work of management and others, and the definition of a significant deficiency. We urge the Board to carefully consider our comments, which we believe will promote a more efficient, cost-effective, and balanced evaluation of internal controls over financial reporting.

Inconsistencies between the Framework and Proposed AS

The general framework of the Proposed AS appropriately identifies a number of key concepts common to audits and evaluations of internal controls including the following:

- **Auditor's Objective in an Audit of Internal Control Over Financial Reporting**

- *The auditor's objective in an audit of internal control over financial reporting is to form a basis for expressing such an opinion, the auditor must plan and perform the audit to obtain reasonable assurance about whether the company maintained, in all material respects, effective internal control over financial reporting…..*

- *To obtain reasonable assurance, the auditor evaluates the assessment performed by management and obtains and evaluates evidence about whether the internal control over financial reporting is designed and operated effectively…..*

- **Inherent Limitations in Internal Control Over Financial Reporting**

- *Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations…..*

- **Reasonable Assurance**

- *Management's assessment of the effectiveness of internal control over financial reporting is expressed at the level of reasonable assurance. The concept of reasonable assurance is built into the definition of internal control over financial reporting and also is integral to the* *auditor's opinion. Reasonable assurance includes the understanding that there is a relatively low risk that material misstatements will not be prevented or detected on a timely basis. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance.*

- **Materiality Considerations in an Audit of Internal Control Over Financial Reporting**

- *The auditor should apply the concept of materiality in an audit of internal control over financial reporting at both the financial-statements level and at the individual account-balance level……*

- *The same conceptual definition of materiality that applies to financial reporting applies to information on internal control over financial reporting, including the relevance of both quantitative and qualitative considerations.*

Despite recognition of the key concepts of reasonable assurance, inherent limitations, and materiality in the general framework of the Proposed AS, the Proposed Standard itself abandons these critical concepts through the inappropriate use of words such as "all", "each," and "entire". We believe that through the use of these "all inclusive" words the Proposed AS directly contradicts the basic notion of reasonable assurance, inherent limitations, and materiality and in so doing sets an unattainable standard for both the registrant and the independent auditors in carrying out their responsibilities under the Proposed AS. More specifically, we do not believe it would be either cost-beneficial or possible to document, test, and attest to the effectiveness of "all" or "each" control within the "entire" internal control over financial reporting system as could reasonably be construed by the language in the Proposed AS. It is our assumption that the use of words such as "all", "each", and "entire" was unintended as it is inconsistent with the PCAOB's recognition in it's general framework that there are inherent limitations in any internal control system such that obtaining "absolute assurance" of its effectiveness cannot be obtained. Moreover, we believe the PCAOB recognized that fact when it suggested that when testing internal controls over financial reporting the tests should be designed to obtain "reasonable assurance" that the controls are operating effectively. Although the term "reasonable assurance" is not adequately defined in either the Proposed AS or related literature, it is our understanding that it has historically incorporated judgment and an assessment of materiality in designing tests to meet the "reasonable assurance" threshold which is definitively different than the "absolute assurance" threshold implied by the use of words such as "all", "each," and "entire". Accordingly, we strongly suggest eliminating words such as "all", "each," and "entire" in the Proposed AS as they suggest the imposition of a level of review and testing that is neither cost-beneficial or possible.

Testing Operating Effectiveness

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?

We believe the independent auditor should apply their judgment and place appropriate reliance on their previous experience within the industry and with the registrant when determining the evidence necessary to support their opinion on management's assessment of internal controls over financial reporting. We believe the independent auditor's knowledge and understanding of a registrant's internal control structure is enhanced with experience as many components within a company's internal control structure do not change significantly from year to year. Accordingly, the independent auditor should be permitted to appropriately leverage this experience and modify the timing and extent of internal control testing aimed at determining whether controls over financial reporting are appropriately designed and operating effectively. Assuming the preceding, the independent auditor would appropriately focus their substantive tests on areas within the registrant's internal control structure that have changed.

Use of the Work of Management and Others

The Proposed AS summary suggests that the work performed by management in connection with its assessment of internal controls over financial reporting can have a significant effect on the nature, timing and extent of the work performed by the independent auditor, however, the Proposed AS does not appear to support this statement given its restrictions on the use of the work of management and internal auditors.

Question 13:

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

We believe the complete restriction placed on the use of the results of testing performed by management and internal auditors is inappropriate and severely limits the independent auditor's ability to appropriately alter the nature, timing and extent of their substantive tests. While we generally understand the Board's attempt to identify more critical areas for the independent auditors in the current business environment, we believe the work of management and internal auditors should not be ignored when determining the nature, extent and timing of substantive audit procedures. We believe that to the extent the independent auditor's consideration of work completed by internal auditors expressly considers their independence, approach, and competence there is no reason their work should not be relied on. The same approach should be applied to the work of management, not withstanding their lack of independence.

Question 9:

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

We believe walkthroughs would be very time-consuming and costly for the independent auditors to complete for each of the registrant's significant processes. Moreover, the independent auditor's primary focus should be on evaluating the design and operational effectiveness of internal controls over financial reporting. In contrast, documenting internal controls over financial reporting is typically completed by management and internal auditors. Furthermore, as noted above in our response to question 11, requiring auditors to perform walkthroughs each year does not appropriately consider the independent auditors previous experience and knowledge of the industry or the registrant. Assuming documentation supporting the control environment already exists, we believe the independent auditor should only perform walkthroughs of significant processes on a limited test basis applying their judgment by taking into account their previous experience with the industry and with the registrant to validate their understanding of the process as documented by management and the internal auditors.

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?

We believe the Proposed AS does not appropriately leverage the work completed by internal auditors. The Proposed AS would require significant duplication of work and inefficiencies resulting in a higher cost of performing substantive tests by the independent auditors. Accordingly, we believe the Proposed AS should consider the outcome of the required assessment of the competence and objectivity of the internal auditors as outlined in AU § 322 and allow the independent auditors to apply an appropriate level of reliance on the work of internal auditors. AU § 322 requires the independent auditor to obtain information on the educational level and professional experience of internal auditors (including professional certifications and continuing education), audit policies, audit programs and procedures, practices regarding assignment of internal auditors, supervision and review of internal auditors' activities, quality of working-paper documentation, reports and recommendations, an evaluation of internal auditors' performance, and consideration of the organizational status of the internal auditors. We believe that, depending on the outcome of this comprehensive review, the independent auditors should be allowed to rely on the work of internal auditors.

Significant Deficiency Definition

Question 17:

Will the definitions in the proposed standard of a significant deficiency and material weakness provide for increased consistency in the evaluation of deficiencies? How can the definitions be improved?

We believe the definition of a significant deficiency in the Proposed AS is ambiguous, would be difficult to apply, and therefore would not provide for increased consistency in the evaluation of deficiencies (both individually and collectively). To improve upon the definition in the Proposed AS we believe the PCAOB should incorporate specific evaluative criteria into the definition against which reporting entities could easily and consistently evaluate deficiencies in internal controls over financial reporting. Moreover, we believe the evaluation criteria should give due consideration to both the nature and the actual (or potential) materiality of the item in relation to the annual or interim financial statements to which they (it) relate(s).

The definition in the Proposed AS of a significant deficiency in internal controls over financial reporting is as follows:

> *A significant deficiency is an internal control deficiency that adversely affects a reporting entity's ability to initiate, record, process, or report external financial data reliably in accordance with generally accepted accounting principles. A significant deficiency is a deficiency that, by itself or a combination of deficiencies, results in more than a remote likelihood of a misstatement of the annual or interim financial statements that is more than inconsequential in amount and would not be prevented or detected.*

We do not believe the term "more than a remote likelihood of a misstatement of the annual or interim financial statements that is more than inconsequential" provides clear, objective criteria against which one can easily and consistently evaluate deficiencies in internal control over financial reporting. More specifically, we believe that without evaluative criteria against which to evaluate deficiencies, reporting entities will interpret and apply the terms "more than a remote likelihood" and "more than inconsequential" in an inconsistent manner. Moreover, when developing the evaluative criteria we suggest that certain concepts be incorporated to eliminate the potential that minor deficiencies, that exist in even the most well-controlled business environments, are not inappropriately designated as significant deficiencies as that could have the unintended consequence of de-sensitizing relevant parties (i.e. financial statement preparers, users, and independent auditors) to the importance of significant deficiencies.

To ensure that deficiencies (both individually and collectively) are consistently evaluated against a set of objective criteria designed to identify only those individual and collective deficiencies that warrant designation as a significant deficiency we propose the following definition and set of evaluative criteria:

Proposed Definition – Significant Deficiency

> *A significant deficiency is a deficiency in internal controls over financial reporting that adversely affects a reporting entity's ability to initiate, record, process, or report external financial data reliably in accordance with generally accepted accounting principles. A significant deficiency is a deficiency that, by itself or in combination with other deficiencies, results in the reasonable possibility of a misstatement of the annual or interim financial statements that would not be prevented or detected and that by its nature or amount, represents a misstatement that would affect the judgments of a reasonable investor or creditor.*

Proposed Evaluative Criteria – Nature of the Deficiency

When evaluating the nature of a deficiency (or combination of deficiencies) in internal controls over financial reporting the following factors should be considered:

- Whether the related actual (or potential) misstatement arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate;
- Whether the related actual (or potential) misstatement masks a change in earnings or other trends;
- Whether the related actual (or potential) misstatement changes a loss into income or vice versa; and
- Whether the related actual (or potential) misstatement involves concealment of an unlawful transaction.

Proposed Evaluative Criteria – Actual or Potential Significance of the Deficiency

When evaluating the significance of a deficiency (or combination of deficiencies) the following criteria should be used as a guide to determine whether the deficiency (or combination of deficiencies) is significant (or has the potential to become significant) as it relates to the annual or interim financial statements of the relevant registrant:

- Does the deficiency (or combination of deficiencies) concern information related to the registrant that would cause a reasonable investor to make a different decision with regard to the purchase of the registrant's securities (either debt or equity)?
  - Does the deficiency (or combination of deficiencies) significantly affect the reported earnings or financial strength ratings of the registrant? A deficiency affecting reported earnings but not the financial strength of the registrant may not affect the investing decisions of a holder of the registrant's debt securities.

- Are the financial statements filed by the registrant for a specific purpose (e.g. are they required to support the issuance of certain products – e.g. variable insurance policies)?
  - If so consider how the purchasers of those products would view the deficiency in light of what information they consider important to their investment decision.

- Determine whether the deficiency (or combination of deficiencies) could significantly affect the registrant's financial strength ratings.
  - Does the deficiency significantly affect the registrant's regulatory capital ratios, if any?
  - Does the deficiency significantly affect the registrant's asset/liability management, asset quality, liability duration, or key financial strength measures?
  - Does the deficiency (or combination of deficiencies) significantly affect the run-rate of the registrant's business operations?

I can be reached at (847) 402-2213 if you would like to discuss the contents of this letter.

Sincerely,

Samuel H. Pilch

Samuel H. Pilch
Controller
The Allstate Corporation