The Institute of Internal Auditors

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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

Dear Sir/Madam:

The Institute of Internal Auditors (IIA) commends the efforts of the Public Company Accounting Oversight Board (PCAOB) to promote effective corporate governance. The IIA has long advocated that good governance and accurate financial reporting emanate from the balanced interaction of board members, executives, internal auditors, and external auditors.

Established in 1941, The IIA is an international professional organization with world headquarters in Altamonte Springs, Florida. We have over 87,500 members worldwide in internal auditing, governance, internal control, IT audit, education, and security; many of whom are also members of professional accountancy bodies. The IIA, with representation in more than 100 countries, is the acknowledged global leader in standards, certification, education, research, and technological guidance for the internal auditing profession. The IIA maintains the *International Standards for the Professional Practice of Internal Auditing (Standards)*, which are recognized around the world and support the internal auditing profession.

The IIA represents over 37,700 members in 133 chapters across the United States and is the principal voice of the internal auditing profession. The IIA is well positioned to offer unique insights into issues related to improving corporate governance, risk management, and control processes. In December 1999, The IIA adopted the following definition of internal auditing that acknowledges the role of internal auditing in corporate governance:

*"Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes."*

Since the adoption of this definition, The IIA has intensified its efforts to contribute to the reform of governance practices of public companies around the world. The IIA is pleased to provide our views regarding your proposed rules, released October 7, 2003, for public comment. Leading IIA members, including prominent chief audit executives from various industries, have contributed to developing our response. We also gathered information from a survey of our chief audit executive members, and received comments from over 370 of them.

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Overall, we found the proposed standard's approach to be very detailed and prescriptive. This seems to contradict the move towards principles-based standards, which most oversight and regulatory bodies are striving to achieve. We also believe that too much emphasis is placed on explicit procedures as opposed to the auditor's use of judgment, risk assessment, and analyses. Finally, we found that the prescriptive directives contained in the detailed standard contradict general comments in the introduction that discuss the ability of the auditor to rely on management and internal audit's work.

From the internal auditor's unique perspective as both a key contributor to corporate governance and as an objective observer of that process, The IIA offers the following comments:

1. We think that the auditor should be able to place much more reliance on a competent and objective internal audit function than the proposed standard indicates. There should also be "limited" and "full" reliance categories instead of the "non-reliance" category within the proposed standard. It should be left up to the professional judgment of the auditor as to the level of reliance to be placed on the work of others in the "limited" category. The proposed standard should express strong reservations about, but not prohibitions against, work related to pervasive or sensitive key controls that fall into the new "limited" category, e.g., fraud and information technology controls. As part of the understanding and evaluation of management's process used as a basis for management's assessment, the auditor should assess the competence and objectivity of the parties performing the procedures to determine the level of reliance that can be placed on the procedures performed by others.

2. Audit committees are assigned primary responsibilities for assessing and monitoring governance practices, so they must have sufficient resources to fulfill them. We continue to recommend that all publicly held companies should be expected to establish and maintain an objective, adequately resourced, and competently staffed internal audit function to provide management and the audit committee with ongoing assessments of the organization's risk management processes and the accompanying system of internal control. Lack of an effective internal audit function is an indicator of weak monitoring of controls and the control environment. If an internal audit function is not present, the board of directors should disclose in the company's annual report why the function is not in place and the auditor should consider such disclosure in reporting significant deficiencies. Recently, the U.S. Securities and Exchange Commission (SEC) approved the New York Stock Exchange's requirement that listed companies have an internal audit function, at our recommendation, and we urge the PCAOB to support this initiative more broadly. In addition, we recommend that the internal audit function practice in accordance with The IIA's Standards, and we are pleased that this is recognized in the proposed standard.

3. The standard should be consistent with the requirement that the auditor examine management's assertion of the efficiency and effectiveness of internal controls over financial reporting and evaluate whether it is fairly stated in all material respects. The proposed standard should not establish a new requirement beyond that of the SEC's rules that the auditor must obtain the same level of assurance as is expected of management. The proposed standard should reduce the overly prescriptive nature of the audit testing to be performed, (e.g., walkthroughs and IT general controls), and require the auditor to perform those procedures necessary to obtain a reasonable level of assurance as to management's assertion regarding the effectiveness of the controls. The guidance should focus on how to properly evaluate management's assertion, not establish a new requirement to complete a separate audit of internal controls over financial reporting.

4. The requirement in the proposed standard that recommends the auditor evaluate audit committee oversight should be deleted. The evaluation of the audit committee by the auditor presents a conflict of interest because the audit committee is normally charged with the oversight (hiring, compensation, termination) of the public accountant; therefore, a lack of independence on the part of the auditor would exist. Governance evaluation of the performance of the various board committees is and should remain a board of directors' responsibility.

5. The proposed standard expands the definition of significant deficiency to include more matters than reflected in the SEC rules. Significant deficiency should be defined as any item requiring the attention of the audit committee. The determination of the deficiency as significant should be based on a consideration of a number of factors and circumstances, not simply the interpretation of two words (remote and inconsequential).

6. With regard to the extent of testing of controls, the auditor should use judgment in determining whether partial reliance on the results of testing from prior years is acceptable. Such reliance will more likely be possible when the design and operations of the controls have not changed significantly from the prior year. The auditor would need to confirm that the risk of an unnoticed change in controls is low when planning on partial reliance on evidence gathered in the prior year.

The enclosed document provides additional details and further recommendations in the areas where we believe the PCAOB can enhance its final rules to further improve governance processes.

We have enclosed copies of two of our recent publications on governance, *Corporate Governance and the Board: What Works Best* and *Audit Committee Effectiveness: What Works Best*, both of these books discuss corporate governance models and the effective interaction of key governance stakeholders. This information may be useful in developing future audit guidance. We also have numerous other publications that promote good governance practices, including the periodical *Tone at the Top*, which is specifically designed to provide useful information for directors who serve on audit committees. These other publications are available for review at our Web site, www.theiia.org.

We appreciate the opportunity to express our views on these important matters and welcome the opportunity to discuss any and all issues with your organization at any time.

Best regards,

William G. Bishop III

<u>Attachment</u>

A - Detailed Comments on the Proposal

B - Reconciliation of PCAOB Questions to IIA Response

<u>Enclosures</u>

1. *Corporate Governance and the Board: What Works Best* – An Institute of Internal Auditors Research Foundation report.
2. *Audit Committee Effectiveness: What Works Best* – An Institute of Internal Auditors Research Foundation report.

# THE INSTITUTE OF INTERNAL AUDITORS (IIA)

## Attachment A

## Detailed Comments on the Proposed Standard - November 21, 2003

The Institute of Internal Auditors (IIA) is supportive of the PCAOB proposal; however, opportunities exist for changes and additions to greatly enhance the proposal. The proposed standard will help those charged with governance responsibilities and increase the confidence of stakeholders. A strong and comprehensive plan of action for implementing the final rules will be vital in obtaining buy-in from the business community.

Our suggestions and answers to many of the questions posed in the *Request for Comment*, with reference to the appropriate sections of the document, are provided below. Our comments are presented according to the 11 key issues identified by our response team. In Attachment B we have included a cross-reference to the proposed PCAOB standard and/or questions involved for each issue. We have also referenced each question below.

### IIA Issue #1 – Reliance on Internal Audit Efforts

<u>Relevant Sections of the PCAOB Proposed Standard:</u>
Paragraphs 108 and 114

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?

**<u>Issues</u>**

1. We commend the efforts of PCAOB to recognize the important unique role of internal auditors. Paragraph 108 is very helpful and is accurate in differentiating the work of internal auditors from others who may not have the competence and objectivity internal audit uniquely possesses. It is very important that the PCAOB set a strong tone supporting internal auditing in organizations.

2. The proposed standard does not place enough emphasis on the work of internal auditors. This can be seen in areas discussed further in this attachment, such as where the external auditors could rely on a competent and objective internal audit function's work in the areas of:

    a. Walkthroughs.
    b. Control environment documentation and testing.
    c. Audits of financial reporting and information technology.
    d. Detection of fraud and pervasive areas such as information technology controls.

3. In the auditor's retesting of internal audit's work in forming a basis for external auditor reliance, we believe that greater specificity is required. There have been many comments regarding implementation of the Sarbanes-Oxley Act (Act) on how to achieve the intent of the Act in a way that is cost effective and sustainable for companies. Reliance on a competent and objective internal audit function's work is important for the PCAOB to emphasize — to demonstrate cost effective and sound ways for auditors to achieve the required level of assurance.

4. In the current standard, a reader could erroneously assume that the auditor must retest some transactions underlying every control that internal auditors test. We suggest that the auditors assess internal audit's work overall and perform valid overall retesting of internal audit's work, but that this does not require retesting of every control that internal audit tests. Not specifying this may risk confusion. The approach and level of retesting should be based on the reliability of internal audit's work overall, not the retesting of every control tested by internal audit.

5. We concur with paragraph 114 in its requirement that the auditor should review all reports issued during the year by internal audit that address controls related to internal control over financial reporting.

**Recommendations**

1. The auditor should be allowed to rely on a competent and objective internal audit function's work in the areas such as: a) walkthroughs, b) control environment documentation and testing, c) audits of financial reporting and information technology, and d) detection of fraud.

2. We continue to recommend that all publicly held companies should be expected to establish and maintain an objective, adequately resourced, and competently staffed internal audit function to provide management and the audit committee with ongoing assessments of the organization's risk management processes and the accompanying system of internal control. Lack of an effective internal audit function is an indicator of weak monitoring controls and control environment. If an internal audit function is not present, the board of directors should disclose in the company's annual report why the function is not in place and the auditor should consider such disclosure in reporting significant deficiencies. Recently, the U.S. Securities and Exchange Commission (SEC) approved the New York Stock Exchange's requirement for listed companies to have an internal audit function, at our recommendation, and we urge the PCAOB to support this proposal.

## IIA Issue #2 – Walkthroughs

Relevant Sections of the PCAOB Proposed Standard:
Paragraphs 79-83 and 104

Question 9 - Are the objectives to be achieved by performing the walkthroughs sufficient to require performance of the walkthroughs?

Question 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?

**Issues**

1. The proposed standard goes well beyond the intent of Sarbanes-Oxley, which requires that the auditors attest to and report on the assessments made by management (Section 404(b)):

   *"(b) Internal Control Evaluation and Reporting — with respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the*

*audit report for the issuer shall attest to, and report on, the assessment made by management of the issuer."*

and not that they conduct an extensive audit of internal controls through walkthroughs of "all the company's significant processes" from

*"Initiating, recording processing, and reporting individual transactions, and controls for all five internal control components and fraud and not just control activities. " (paragraph 80, page A-31 – of Proposed Standard)*

This would also include field visits and interviews of personnel "involved in significant aspects of the process or controls" (paragraph 81, page A-32). The proposed standard then specifies potential questions the auditors should ask.

The focus should be on testing how management made its assessments, and performing tests as required to gain assurance regarding management's assessment process and conclusion. These tests may or may not require the extensive walkthroughs currently specified in the proposed standard. Requiring walkthroughs of all significant processes is a very comprehensive scope depending on the definition of "significant".

2. Requiring the auditors to perform all walkthroughs (page 9 and paragraph 104, page A-38) without the ability to rely on the work of others is excessive and cost prohibitive. This is especially true, considering paragraph 82 (page A-32) which requires that auditors assess whether significant changes in a process flow require them to perform "before" and "after" walkthroughs including changes to computer systems.

   Instead, the auditors should be allowed to rely on walkthroughs performed by others, especially those completed by internal auditors. The focus of the standard should be on the criteria required to rely on the work of others, especially with regard to computer system changes. This would be consistent with other sections of the standard.

In addition to the above two issues, the proposed standard provides too much detail delineating how walkthroughs should be done and examples of questions to ask – almost providing the audit steps – especially in paragraph 81 (page A-32). This should be eliminated to keep the standard crisp. While the procedures and questions are good, a standard is not the place for a "how to." This information should be in appendix material, similar to the sample reports.

## Recommendations

1. For the reasons given above, eliminate walkthroughs from paragraph 104, which specifies that the auditor must complete them.

2. Paragraph 79: Change "walkthroughs are required" to "walkthroughs are a recommended technique based on risk and the availability of reliable work done by others." Precisely define or give guidelines regarding "significant."

3. Paragraphs 80 and 81: Recommend keeping these to the lead sentences and moving the detail on "suggested means to do the work" to an appendix on walkthroughs.

4. Paragraph 82 and 83: No changes, if the work of others can be relied upon.

## IIA Issue #3 – Reliance on the Work of Others

Relevant Sections of the PCAOB Proposed Standard:
Paragraphs 41,42, 103-110, 145, B8, B9, and B22

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

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

Question 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 (e.g. reperform tests of all significant accounts or reperform every test performed by others that the auditor intents to use)?

**Issues**

1. The proposed rules greatly limit the auditor's ability to rely on the work of others.

2. Sampling the work of others should be allowed – particularly when performed in conjunction with the financial audit efforts.

3. Auditors should emphasize judgment based on the competence and objectivity of other resources as to the level of reliance that can be placed on them.

**Recommendations**

1. The auditor must obtain an understanding of internal controls over financial reporting. The auditor should assess the competence and objectivity of management, internal audit, and others to determine the level of reliance that can be placed on procedures performed by them. As part of the understanding and evaluation of management's process(s) used as a basis for management's assessment the auditor should assess the competence and objectivity of the parties performing the procedures to determine the level of reliance that can be placed on the procedures performed by them.

2. Paragraph 103 – Use of the Work of Management and Others. . . [ADD THE FOLLOWING BULLET]

    - The competence and objectivity of those performing the work.

3. Paragraph 104 – There are many areas where the auditor should not use the testing performed by management and others, including: [MODIFY THE THIRD BULLET – adding bolded section]

    - Controls that have a pervasive effect on the financial statements, such as certain information technology general controls on which the operating effectiveness of other controls depend, **unless the auditor determines that the competence and objectivity of internal audit or others performing the work is sufficient to allow for reliance on the results by the auditor**.

## IIA Issue #4 - Principal Evidence Requirements for Auditors

<u>Relevant Sections of the PCAOB Proposed Standard:</u>
Paragraphs 103-109

Question 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?

**<u>Issues</u>**

1. The proposed rules require the auditor to directly perform the procedures that form the principal evidence in expressing their opinion.

2. Allowing internal audit to gather, test, audit, and document principal evidence of the existence and effectiveness of internal controls is not supported by the proposed rules.

3. Allowing external auditors to place partial reliance on the tests performed by internal audit would be more efficient.

**<u>Recommendations</u>**

1. Paragraphs 103-109 - [MODIFY Paragraph 109 – adding bolded content] In addition to following the directions in paragraphs 103-108, the auditor must compile enough of the testing evidence himself or herself so that the auditor's work provides the principal evidence for the auditor's opinion. **The auditor may rely on internal audit testing results to supplement principal evidence based on the auditor's assessment of the competence and objectivity of the internal audit function.**

2. Paragraph B22 - In evaluating controls over . . . through the company's accounting system. [MODIFY BULLET #1 – adding bolded content]

- Because of the pervasive impact of the controls in (1) and the material impact those controls ordinarily have on the financial statements, the auditor should not use the results of testing by management and others within the company, as discussed in paragraph 104, **unless the auditor determines that the competence and objectivity of internal audit or others performing the work is sufficient to allow for reliance on the results by the auditor.**

## IIA Issue # 5 – Should the Auditor's Assurance Levels be the Same as Management's?

<u>Relevant Sections of the PCAOB Proposed Standard:</u>
Paragraph 18

**<u>Issues</u>**

We do not believe, as is stated in the proposed standard (page A-13, paragraph 18) that "Users of the reports ….are entitled to receive the same level of assurance from both management and the auditor…"

We reach this conclusion based on the following points:

1. It is well accepted, and included in the COSO definition of internal control, that management is responsible for internal control. The SEC stated in Final Rule 33-8238: "Management cannot delegate its responsibility to assess its internal controls over financial reporting to the independent accountant." Also, the proposed standard's statement of "Management's responsibilities in an audit of internal control over financial reporting" says that management must accept responsibility for the effectiveness of the company's internal control and for evaluating the effectiveness of internal control."

2. In addition to the assertions required by Section 404, management is required under Section 302 to take responsibility for disclosure controls and to certify conclusions as to their effectiveness.

3. Under Section 906, there are criminal penalties attached to management's knowingly false certifications.

4. The many companies impacted by the Act are implementing more rigorous processes and systems to document and evaluate internal controls. In many cases, this effort has included implementing new systems to support 404 compliance, new evaluation processes, extensive documentation efforts, and related work. These efforts are in addition to the many control assessment activities that management has been performing all along.

Requiring the auditor to provide this very high level of assurance that management provides will be nearly impossible to fulfill and is inconsistent with the concept of auditors needing to obtain "reasonable assurance." Management must take more responsibility for internal controls than the auditor.

**Recommendation**

We recommend that the standard require the auditor to examine management's assertion of the effectiveness of internal control and to evaluate whether it is fairly stated in all material respects, and not require the same level of assurance by the auditor as required by management.

## IIA Issue #6 - Audit Assurance Levels

Relevant Sections of the PCAOB Proposed Standard:
Question 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?

**Issues**

We believe that it is not appropriate for the PCAOB to require that the auditor conduct an audit of internal controls and provide an opinion on their effectiveness.

Supporting this position are the following points.

1. If Congress intended such an audit and opinion by the auditor, it would have included such requirements in the Sarbanes-Oxley Act. Instead, the Act requires the external auditor to attest to and – report on the assessments made by management (Section 404(b)): "(b) Internal Control Evaluation and Reporting — with respect to the internal control assessment required by subsection (a), each

registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by management of the issuer."

2. The many companies impacted by the Act are implementing more rigorous processes and systems to document and evaluate internal controls. The internal audit staffs of these companies are also playing key roles in the compliance effort. These new systems, processes, and testing activities are costing significant time and resources. The proposed standard indicates that "the work that management performs in connection with its assessment can have a significant effect on the nature, timing, and extent of the work of the independent auditor" and that "the more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be." However, the detailed provisions of the proposed standard related to the requirement of the auditor to "obtain evidence about whether internal control over financial reporting is effective", will significantly reduce this reliance and result in significant and duplicative work on the part of the auditor. The most significant of these provisions are as follows:

    - On page A-39, paragraph 109, the proposed standard states that "In addition to following the directions in paragraphs 103-108, the auditor must perform enough of the testing himself or herself so that the auditor's own work provides the principal evidence for the auditor's opinion."
    - The proposed standard requires the auditor to perform "walkthroughs" of significant processes. (page 10 & page A-38, paragraph 104)
    - The proposed standard lists a large number of areas "in which the auditor should not use the results of testing performed by management and others…" These include:
        - Controls specifically intended to prevent or detect fraud (that could have a material impact on the financial statements). (page 14)
        - Controls over period-end financial reporting. (page A-38, paragraph 104)
        - 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. (page A-38, paragraph 104)
    - The proposed standard limits the use of the results of procedures performed by management in the following areas:
        - Controls over non-routine transactions that are considered high-risk. (page 14 and page A-38, paragraph 105)
        - Controls over significant accounts, processes, or disclosures where the auditor as assessed the risk of failure of the controls to operate effectively as high. (page A-38, paragraph 105)
    - The proposed standard (page A-13, paragraph 18) states that "Users of the reports ….are entitled to receive the same level of assurance from both management and the auditor…" and goes on to say that "There is no difference in the level of work or assurance given by the auditor when expressing an opinion on management's assessment of effectiveness or when expressing an opinion directly on the effectiveness of internal control over financial reporting." Requiring the same level of assurance would require significant and duplicative activities on the part of the auditor and is likely very difficult to achieve.
    - The proposed standard (page A-28, paragraph 69) requires the auditor to "Identify each significant process for each major class of transactions affecting significant accounts…" and to perform significant work related to each process.

3. There is a traditional distinction between the auditors directly expressing an opinion on the effectiveness of internal control as compared to determining whether or not management's assessment of their effectiveness is fairly stated.

4. An "attest engagement" concerning matters other than financial statements has traditionally been distinguished from an "audit" of the financial statements. The SEC has also made distinction, and in its recent release adopting rules for management's report on internal controls required by Section

404(a) of the Sarbanes-Oxley Act, the SEC refers to the auditor's report on management's assessment required by Section 404(b) as an "attestation report" which is to be made in accordance with standards for "attestation engagements."

**Recommendations**

1. The proposed standard should not establish a new requirement beyond that of the SEC's rules that the auditor must obtain the same level of assurance as is expected of management. The proposed standard should reduce the overly prescriptive nature of the audit testing to be performed, e.g., walkthroughs, IT general controls, and require the auditor to perform those procedures necessary to obtain a reasonable level of assurance as to management's assertion regarding the effectiveness of the controls. The guidance should focus on how to properly evaluate management's assertion, not establish a new requirement to complete a separate audit of internal controls over financial reporting.

2. The auditor should be required to test and to gather only enough evidence to corroborate or refute management's assertion. The IIA recommends using SAS 65 as a guide in assessing reliance on the work of others.

3. The IIA recommends that the auditor's report should be called an "attestation report" on management's assessment of internal controls rather than referring to it as an "audit" of internal controls over financial reporting which results in an "audit report."

## IIA Issue # 7 – Evaluating Audit Committee Governance

Relevant Sections of the PCAOB Proposed Standard:
Paragraphs 56-58

Question 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?

**Issues**

The proposed standard directs the auditor to evaluate the oversight effectiveness of the audit committee. This adds an additional level of oversight and scrutiny to the audit committee and its activities and actions already implemented by listed company audit committee standards, SEC rules, and auditor independence rules. While the audit committee is one major element in the control environment, this proposed standard weakens the recently strengthened role and responsibility of the audit committee by placing the auditor in the role as oversight over the audit committee. This has the effect of introducing the perception of weakened independence as the audit committee has the given authority to evaluate the performance, qualifications, and independence of the auditor. The audit committee also hires, pays, and dismisses the auditor (Rule 10A-3 of the Exchange Act). Currently the board of directors has a responsibility for receiving committee reports and evaluating performance. The proposed standard in effect removes this responsibility from the board of directors and places it in the hands of the auditors. Both the board of directors' and the audit committee's power and authority and responsibility to the shareholders could become diluted. Governance evaluation of the performance of the various board committees is and should remain a board of directors' responsibility.

Relevant Sections of the PCAOB Proposed Standard:
Question 23 - Will auditors be able to effectively carry out their responsibility to evaluate the effectiveness of the audit committee's oversight?

**Issues**

The proposed standard would require the auditor to be independent in fact and appearance. A reasonable investor could perceive an auditor as having interests that could impair objectivity and impartial judgment when they are responsible to the audit committee for their appointment, evaluation, and fees. In addition, the auditor may not be in a position to factually reach an informed judgment/evaluation on the oversight effectiveness of the audit committee, e.g., the auditors may not be present for the entire audit committee meeting.

Under current rules the audit committee is to establish an audit charter inclusive of all SEC and listed company rules, publicly communicate this all-inclusive charter, evaluate itself and affirm compliance to the charter, and report all of the above to the board of directors and the listing stock exchange. The auditors should not dilute these responsibilities and accountabilities.

**Recommendations**

1. The requirement in the proposed standard that recommends the auditor evaluate the audit committee should be deleted. The evaluation of the audit committee by the auditor presents a conflict of interest as the audit committee is normally charged with the oversight (hiring, compensation, termination) of the public accountant, therefore a lack of independence on the part of the auditor would exist. Governance evaluation of the performance of the various board committees is and should remain a board of directors' responsibility.
2. As the effectiveness of the audit committee is important in ensuring an effective control environment, the standard should include guidance that the absence of effective evaluation of the audit committee's performance by the board with the appropriate objectivity and competence to perform this task is a strong indicator of a weak control environment.

## IIA Issue # 8 – Review of Information Technology Controls

Relevant Sections of the PCAOB Proposed Standard:
Paragraphs 51, 53-55, 104, and B22

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

**Issues**

1. Reliance on internal audit's evaluation of controls should be in all areas, unless the auditor's evaluations of the competence and/or objectivity of internal audit are unsatisfactory.

2. The auditor should be able to rely on the tests performed by the internal auditor in all respects, provided that the internal auditor satisfies the level and type of testing required by the standard.

3. There should not be any "-no reliance-" areas; they should be moved into a "limited reliance" category.

4. PCAOB is taking the position that the auditor must directly test all IT general controls.

5. Internal audit should be viewed as independent from management and as such the auditor should be able to rely on internal audit's work.

**Recommendations**

1. Paragraph 104 – There are many areas where the auditor should not use the testing performed by management ands others, including: [MODIFY THIRD BULLET – adding bolded content]

    - Controls that have a pervasive effect on the financial statements, such as certain information technology general controls on which the operating effectiveness of other controls depend, **unless the auditor determines that the competence and objectivity of internal audit or others performing the work is sufficient to allow for reliance on the results by the auditor.**

2. Paragraph B22 – In evaluating controls over . . . through the company's accounting system. [MODIFY BULLET 1 – adding bolded content]

    - Because of the pervasive impact of the controls in (1) and the material impact those controls ordinarily have on the financial statements, the auditor should not use the results of testing by management and others within the company, as discussed in paragraph 104, **unless the auditor determines that the competence and objectivity of internal audit or others performing the work is sufficient to allow for reliance on the results by the auditor.**

3. There should be "limited" and "full" reliance categories, i.e., there should not be a "non-reliance" category within the standard. It should be left up to the professional judgment of the auditor as to the level of reliance to be placed on the work of others in the "limited" category. The standard should express strong reservations, but not prohibitions, for work related to pervasive or sensitive key controls that fall into this new "limited" category.

## IIA Issue # 9 – Fraud Requirements

Relevant Sections of the PCAOB Proposed Standard:
Paragraphs 24-26

**Issues**

1. Similar to our issues on the review of information technology controls, reliance on the testing of others should be allowed, unless the auditor's evaluations of the competence and/or objectivity of internal audit are unsatisfactory. The same logic applies here as to other areas of reliance on testing of others.

2. The only difference in the consideration of the risks of fraud as compared to other areas is that there are certain levels of expertise in assessing fraud that go beyond the normal professional levels of competency of external auditors and internal auditors. For instance, The IIA's *Standards* state: "The internal auditor should have sufficient knowledge for identifying the indicators of fraud but is not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud." When appropriate, external auditors and management should involve persons whose primary responsibility is detecting and investigating fraud. PCAOB should consider whether to make reference to this.

**Recommendations**

The proposed standard should express reservations, but not prohibitions, for work related to pervasive or sensitive key controls for fraud prevention and detection. As part of the understanding and evaluation of management's process used as a basis for management's assessment, the auditor should assess the competence and objectivity of the parties performing the procedures to determine the level of reliance that can be placed on the procedures performed by others.

## IIA Issue # 10 – Definition of Significant Deficiencies

Relevant Sections of the PCAOB Proposed Standard:
Question 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?

Question 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?

**Issues**

1. The definition proposed for a *significant deficiency* is stated too broadly. GAAS and Attestation Standards issued by the AICPA define *material weaknesses* and *reportable conditions*. The final rules issued by the SEC related to the requirements of §404 of the Sarbanes-Oxley Act of 2002 state that the term *significant deficiency* has the same meaning as the term *reportable condition* (footnote 73). The PCAOB proposed standard has expanded the meaning of significant deficiency/reportable condition beyond the original meaning of a reportable condition.

2. There is a large difference between a small error and an error that would result in a material misstatement of financial statements. With the current proposal, any control weakness that could allow an error that is not inconsequential will be considered a significant deficiency. Inconsequential is difficult to define and will likely result in minor weaknesses considered as significant deficiencies. The term significant deficiencies should be reserved for those deficiencies where errors of some importance could occur. In addition, reportable conditions were not precisely defined and were left to auditor judgment as to which issues were of enough importance to report to the audit committee. The proposed definition of significant deficiency has been defined to include essentially all weaknesses that could result in any observable error, as anything that is not irrelevant (defined as inconsequential per Webster's Dictionary) is now "significant." This category should only include those weaknesses with enough importance to warrant the attention of the audit committee.

3. An example of the potential result of the current proposed definition is included in example D1 of Appendix D. In this example, a weakness would allow errors in the financial statements, but would not allow errors that would result in a material misstatement due to adequate compensating controls. However, this weakness is considered a significant deficiency because it could allow errors that are more than inconsequential. The inherent risk in this example of a material misstatement, coupled with the presence of effective high-level compensating controls, should not result in a weakness in internal controls rising to the level of attention by the audit committee. This weakness should not result in a material misstatement nor "grow into" such a weaknesses.

4. The definition of significant deficiency should not rely on two key words (i.e., remote and inconsequential) but should be explained through a discussion of the concepts. This is a difficult concept to define and brevity of words is not possible. The standard should describe the attributes of a weakness which would cause it to be considered a significant deficiency. These attributes would likely include: potential to become a material weaknesses, pervasiveness in longevity and occurrence, involving amounts that are important and normally warrant management's immediate attention when identified, occurrence in areas with high inherent risk of errors, lack of compensating controls, and ability of management to manipulate financial statements as a result of the weakness.

## Recommendations

1. The proposed standard has expanded the definition of significant deficiency to include more matters than are reflected in the SEC rules. Significant deficiency should be defined as any item requiring the attention of the audit committee. The determination of the deficiency as significant should be based on a consideration of a number of factors and circumstances, not simply the interpretation of two words (remote and inconsequential).

2. The examples in Appendix D could be improved by removing the immediate classification of the deficiencies as significant primarily because of the potential errors being more than inconsequential. The determination of the deficiency as significant should be based on a consideration of more factors and circumstances, which would then need to be added to the examples.

## IIA Issue # 11 – Rotation of Audit Work

Relevant Sections of the PCAOB Proposed Standard:
Paragraph 101

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 assertion?

## Issues

1. It is appropriate to require an auditor to obtain evidence of the effectiveness of controls for relevant assertions for all significant accounts and disclosures every year, but not with a prohibition of using some of the audit evidence obtained in previous years to support his or her current opinion on management's assertion. Requiring evidence of effectiveness every year does not preclude relying, in part, on evidence obtained in prior years.

2. The prohibition against auditors relying on evidence obtained in prior years (i.e., using a rotational audit plan) may reduce the effectiveness and efficiency of the audit. The proposed standard requires the auditor to obtain sufficient evidence each year, which is interpreted as prohibiting rotational areas of emphasis in audit testing from year to year. Rotating audit emphasis from year to year is a well-established technique. Many processes and control systems do not change significantly from one year to the next. This can be validated through sufficient evidence gathering during the planning stage of an audit. Requiring an auditor to test an area at the same level each year ignores this common situation, reducing the efficiency of the audit. In addition, rotational testing allows an auditor to focus

deeply on some areas in a given year. This deep level of testing brings a different perspective than the auditor would get from a “minimum” level of testing required to be performed each year.

3. Rotating the depth of audit testing over a series of years does not preclude an auditor from obtaining sufficient audit evidence to support an opinion each year. Professional judgment should be allowed for the auditor to choose when he or she can rely on extensive audit work in a prior year, having confirmed the lack of significant changes in the design or operating effectiveness of controls.

4. The wording of the current proposed standard is confusing as to the acceptability of rotational testing. The introduction explanation on page 12 states that the new rules – “Resolves the issue of the extent of testing from year to year (the ‘rotating tests of controls’ issue).” However, paragraph 101 of the proposed rules directs the auditor to change the extent of testing from year to year and increase or decrease the number of tests each year. These directives imply either a rotational testing approach, or interjecting extraneous tests each year.

## Recommendations

Paragraph 101 – *Extent of Tests of Controls*. [MODIFY – adding bolded content].

Each year the auditor must obtain sufficient evidence about whether the company’s internal control over financial reporting, including the controls for all internal control components, is operating effectively. The auditor also should vary from year to year the nature, timing, and extent of testing of controls to introduce unpredictability into the testing and respond to changes in circumstances. For example, each year the auditor might test the controls at a different interim period; increase or reduce the number and types of tests performed; or change the combination of procedures used. **The auditor should use judgment to determine whether partial reliance on the results of testing from prior years is acceptable. Such reliance will more likely be possible when the design and operations of the controls have not changed significantly from the prior year. The auditor would need to confirm that the risk of an unnoticed change in controls is low when planning on partial reliance on evidence gathered in the prior year.**

## THE INSTITUTE OF INTERNAL AUDITORS (IIA)
## Attachment B - Reconciliation of Questions to IIA Response

| Question | Relevant Reference in IIA Response |
|---|---|
| 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? | Issues #5, #6 |
| 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? | Issues #5, #6 |
| 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 the work with regard to the financial statements comparable to that required to complete the financial statement audit? | -- |
| 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 firms? | -- |
| 5. Should the Board, generally or in this proposed standards, specify the level of competence and training of the audit personnel that is necessary to perform specified auditing procedures effectively? | -- |
| 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? | Issues #4, #6 |
| 7. Is it appropriate that the Board has provided criteria that auditors should use to evaluate the adequacy of management's documentation? | -- |
| 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? | -- |
| 9. Are the objectives to be achieved by performing walkthrough sufficient to require the performance of walkthroughs? | Issue #2 |
| 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? | Issues #1, #2, #3 |
| 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? | Issue #11 |
| 12. To what extent should the auditor be permitted or required to use the work of management and others? | Issues #1, #3, #9 |
| 13. Are the three categories of controls and the extent to which the auditor may rely on the work of others appropriately defined? | Issues #3, #8, #9 |

| **Question** | **Relevant Reference in IIA Response** |
|---|---|
| 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? | Issue #1 |
| 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 (e.g. reperform tests of all significant accounts or reperform every test performed by others that the auditor intents to use)? | Issue #3, #8, #9 |
| 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? | Issue #4 |
| 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? | Issue #10 |
| 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? | Issue #10 |
| 19. Is it necessary for the auditor to evaluate the severity of all identified internal control deficiencies? | -- |
| 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? | -- |
| 21. Are the matters that the Board has classified as strong indicators that a material weakness in internal control exists appropriately classified as such? | Issues #7, #10 |
| 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? | Issue #7 |
| 23. Will auditors be able to effectively carry out their responsibility to evaluate the effectiveness of the audit committee's oversight? | Issue #7 |
| 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 engagement? | Issue #7 |
| 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? | -- |
| 26. Are there circumstances where a qualified "except for" conclusion would be appropriate? | -- |
| 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? | Issue #6 |

| Question | Relevant Reference in IIA Response |
|---|---|
| 28. Should the Board provide specific guidance on independence and internal control-related non-audit services in the context of this proposed standard? | -- |
| 29. Are there any specific internal control-related non-audit services the auditor should be prohibited from providing to an audit client? | -- |
| 30. Are the auditor's differing levels of responsibility as they relate to management's quarterly certifications versus the annual (fourth quarter) certification, appropriate? | -- |
| 31. Is the scope of the auditor's responsibility for quarterly disclosures about the internal control over financial reporting appropriate? | -- |