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PCAOB Community Input

<u>Questions regarding an integrated audit of the financial statements and internal control over financial reporting:</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?

Footnote 3 provides a quality explanation of the term “audit of internal controls” as used in this standard. We have found it useful to use the term “certification” as a way to differentiate the auditor attestation of management’s assessment of internal controls over financial reporting from a financial statement audit. This allows us to talk about the process without creating confusion and provides a distinct terminology for the internal control assessment and attestation. In addition we have started using the term “Certifying Authority” to describe any registered public accounting firm that can perform an attestation of internal controls over financial reporting. Again, this allows us to provide a clear discussion of the whole process, even though this may be the same team that performs the financial statement audit. It also, helps everyone in understanding the process if the Auditor of the financial statements is not the same as the Auditor that will perform the attestation of internal controls over financial reporting.

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 high level of understanding is required to provide an attestation, the standard still requires the auditor to base their attestation on the auditor’s own work. (In Paragraph 109- “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.”) It would be better for the firm that performed the audit to provide the attestation, but this service could be provided by another firm using the same standards. The standard should allow the audit committee the ability to select the auditor for the attestation, but logic would recommend that the same auditor perform both services.

It seems that the Audit committee should be allowed to make this choice in any case where they see a need to provide the additional oversight. If the independence of the auditor is questioned as it relates to Internal Controls, then the Audit committee should be allowed the option of retaining the services of a second registered auditor to act as the Certifying Authority for Internal Controls over Financial Reporting. By providing the guidance and flexibility the Board allows the Audit Committee to act on conditions that exist due to outside influences.

The Audit Committee might, also, choose to use a second auditor for the attestation in years when they are changing to a new auditor as a way to begin the transition process.

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?

It seems that paragraph 109 would require the auditor to perform an appropriate level of work. In this case the PCAOB might want to provide additional guidance to issuers and auditors.

<u>Question regarding the costs and benefits of internal control:</u>

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?

Yes, it is the responsibility of Management to control costs and to ensure that the correct depth is achieved. See APPENDIX E

Question regarding the audit of internal control over financial reporting:

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.

This should be part of the responsibility of the audit company in gaining status as a certifying authority. It should not be part of this standard, but should be part of the standards for registration of public accounting firms as certifying authorities. The Board should provide guidance to registered firms and hold them accountable for the work of their auditors.

<u>Questions regarding evaluation of management's assessment:</u>

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, but it should be extended in the future to include all internal controls which directly affect the internal controls over financial systems (i.e. data security, storage media).

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

Yes, documentation is a major part of being able to communicate and perform internal controls. If documentation is not in place, then management cannot provide any real assurance that they have provided employees or the Board of Directors/Audit Committee with an understanding of internal control structures. Many issues related to ensuring that financial reporting is properly performed and that management is informed of the results in a timely fashion are related to a lack of documentation. Documentation is a cornerstone of building a long-term risk management structure (ref. COSO). Management and the Audit Committee should use documentation to drive expectation and provide employees with direction and understanding of internal control standards and performance.

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?

This should be a material weakness, since without documentation you have no solid structure that employees can refer to when needed. This is the backbone of internal controls, ethics, and general risk management.

Questions regarding obtaining an understanding of internal control over financial reporting:

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

Yes, but it would help reduce the cost to small and mid-sized companies if the auditor could use documented walkthroughs by others for some of this work. This is just another type of testing and is one of the best ways to understand how an internal control works. Management should be doing this type of testing as part of the evaluation and design process, so documentation of results of walkthroughs should exist and could be used as part of the auditor's evaluation. By allowing the auditor to use this work product the Board could help reduce the cost of Sarbanes-Oxley compliance.

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?

See answer to question 9.

Question regarding testing operating effectiveness:

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?

This appears to be another area where it makes sense for the Board to start with the lesser requirement now and move to a more stringent requirement in the future. This will allow issuers the ability to gain basic compliance now and build structures that can meet tougher requirements in the future. The Board might want to include some guidance about building systems that reach for a higher level than is currently required. Management needs to understand that meeting the minimums is not the goal of Sarbanes-Oxley and that the Board is willing to increase the requirements for certification if the goal of providing investors with quality financial reports is not being met.

Questions regarding using the work of management and others:

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

This is a very tough question, but it seems that the auditor should use the work of management and others in an effort to keep the cost of compliance down. However, the auditor needs to have the ability to choose that level to preserve their independence. As the auditor works for the Audit Committee, then the Board should allow the Audit Committee oversight on this issue. This is another area that the Board should take the opportunity to provide guidance on this issue. The Audit Committee should be reminded that while they have a responsibility to protect the independence of the auditor, they also have a responsibility to shareholders for the cost of compliance. The Audit Committee should work with the auditor to ensure that the auditor uses the work of management and others to help keep these costs in check. In addition, the Board should look at *how* an Audit firm approaches using the work of others during reviews for future registration.

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

No, this is not really well defined, and difficult to locate within the standard. I had to look for the area that I believe you are talking about in this question. I think you are referring to paragraphs 103 to 110. I really did not get three distinct categories from this discussion. It might help to clarify these categories.

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?

It is very hard to determine what the “proper level” of using the work of others is. The auditor should be able to use the work of others if the reported results have appropriate validations. This is especially true when we are talking about automated controls and general computer controls. In addition with proper test processes, the auditor should be able to use non-subjective testing. Again, it would be proper for the auditor to re-perform random samples of the testing to validate the reported results. This would allow the auditor to use a greater body of work and help reduce the cost of compliance. This would, also, provide the auditor, those doing work for management, and management with additional assurances that work done for the attestation was being performed properly.

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)?

Reperformance level should be set by the Audit Committee in conjunction with the auditor. The level of reperformance should not be so high as to require the auditor to repeat a large portion of the work done by management, internal auditors, management consulting firms, or others working to provide support for Sarbanes-Oxley compliance. We do not think that the Board would serve the investing public by attempting to set a standard level of reperformance. This could be taken as a minimum level that should be done. It seems that a better way to approach this is to provide guidance and examples of when the Audit Committee should expect to increase or decrease the level of reperformance by the auditor. Statutory reperformance levels should not be available as a means for the auditor to increase billable hours, nor should it be an excuse by the Audit Committee to limit reperformance by the auditor.

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?

This may not be the best answer for this area. What if the auditor is using the work of another independent source that has provided a large body of work on internal controls? In this case the auditor could be required to increase the amount of reperformance to a level that would not provide additional assurance on the state of internal controls, but would meet the requirement to obtain the evidence on his or her own work. In a case like this the public investor does not gain addition assurances and the auditor is not provided with additional evidence. It might be better to allow the auditor to support their evidence with the work of others as long as the auditor has reperformed a set of random test cases to prove the validity of the results being provided. In addition, it will help small and mid-sized public companies if they are able to use the work of others to help reduce the costs of compliance.

<u>Questions regarding evaluating results:</u>

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?

In talking with a number of CXOs and management consultants, it appears that an improved understanding of the term “material” is needed. Without a good understanding of what is meant by “material,” management and employees will have trouble understanding when a significant deficiency or a number of significant deficiencies reach the level of a material weakness. The examples help, but it would be useful to have “material” clearly defined in this standard.

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?

The cited examples are good; however, we think that some additional scenarios need to be added.

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

No, if the deficiencies are not in controls over financial reporting. Issuers should be encouraged to test and report on all internal controls. In addition, they should be encouraged to have management evaluate, assess and plan remediation for these deficiencies in all internal controls. In the future the Board should ramp this up to include all internal controls over financial systems as this will provide additional assurances to the investing public.

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?

Yes. Management should always be provided with a report on issues that have been found in any internal control, even if those deficiencies are not part of current compliance requirements. By reporting these conditions the auditor would be meeting the spirit of Sarbanes-Oxley by supporting improved internal controls in all areas. We must remember that it is in the best interest of all parties to improve and maintain internal controls.

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

Paragraph 126 seems clear and appropriate.

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?

Yes and no (see our answer to question 23, and paragraphs 56 to59).

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

This question has many components, with the evolution of responsibilities between management and the Audit Committee this question needs to be revisited after we have an operational understanding of the compliance process.

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, withdrawal is not necessary. The auditor must report the lack of audit committee oversight. As the Act has created a separation of powers, so should the Board. Management and the Audit Committee have separate responsibilities and therefore must have separate reports for failing to meet those responsibilities. This is going to be an evolutionary process and should be revisited next year.

<u>Questions regarding forming an opinion and reporting:</u>

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?

Not if management has recognized the material weakness and provided the auditor with a plan for remediation of the issue. In this case the auditor should be able to provide an opinion that would be adverse only if the issuer did not follow through with the plan, or another form of conditional opinion that does not punish management for providing a truthful report on the condition of internal controls over financial reporting. While it is true that the existence of a material weakness has damaged the ability of the public investor to trust the financial report in some way, it does not mean that the report was incorrect. If management found and corrected the weakness before it created an issue with financial reporting they should not be punished or penalized for reporting the issue. It is not the goal of Sarbanes-Oxley to punish; the true goal is improved financial reporting. That goal is not enhanced by negative results for positive actions.

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

Yes, see our answer to question 25.

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?

No, it should address both. If management fairly states an adverse condition, then the Board should not punish management by causing an adverse opinion. See our answer to question 25.

Questions regarding auditor independence:

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

Yes, we need to have a better understanding of how to determine if independence of the auditor has been broken and what action will be required of the issuer when that happens. This should include a discussion of how to limit the cost to the issuer if they have no fault in the loss of independence. This is another instance where the issuer could be forced to incur costs due to circumstances beyond their control. The Board needs to address this type of issue and provide some way to mitigate the costs that will be incurred.

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

Restate the three rules from the SEC, and specifically state that a solid line should be drawn by the Board on non-audit services related to internal controls. By looking at the literature that is available, many auditors still feel that it is appropriate to provide management with services that could become part of an audit of internal controls. This shows a lack of understanding. The Board should try to find some specific examples of these issues. We note the position of Grant Thorton as an example of an audit company that is going the other direction. This shows that even the large audit firms do not have consensus on this issue. Many of the problems that this legislation is attempting to address are due to the lack of distance or objectivity many accounting firms have in relation to their own work product.

Questions regarding auditor's responsibilities with regard to management's certifications:

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, this really helps to limit the costs of compliance and reduces the requirements on smaller companies. This should not create any problems with reporting as real time reporting requirements should ensure that any material issues are reported. (See Paragraph 185 to 190)

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

Currently the auditor’s responsibility is appropriate; in the future this is another example where management should also be part of the disclosure process in the future.