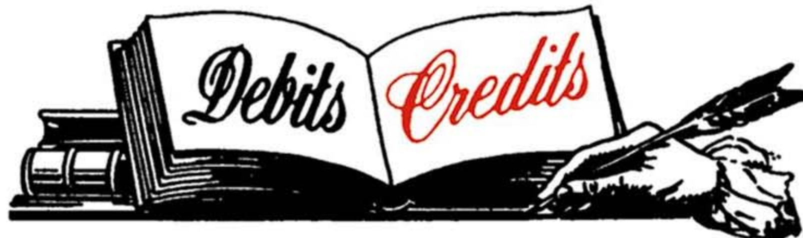
FINANCIAL MANAGEMENT DIVISION

SECURITIES INDUSTRY ASSOCIATION



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November 21, 2003

VIA E-MAIL – comments@pcaobus.org

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

Re: PCAOB Rulemaking Docket Matter No. 008—Audit of Internal Control Over Financial Reporting

Ladies and Gentlemen:

The Financial Management Division of the Securities Industry Association[1] appreciates the opportunity to comment on the Public Company Accounting Oversight Board's (the "Board's")

[1] The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and

Proposed Auditing Standard, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements" (the "Proposed Standard").[2]

We support the Proposed Standard, and share the Board's view that effective internal control over financial reporting is necessary to ensure that investors and others may rely on a company's financial reporting. We do have comments on specific areas covered by the Proposed Standard. We are concerned that in most of these areas, the Proposed Standard, without revision, will require significant work and resources to be expended by auditors and companies without producing a commensurate benefit for investors and others relying upon the integrity of a company's financial statements.

Our comments and requests for clarification relate to the following aspects of the Proposed Standard:

- The Board should clarify that regulatory compliance unrelated to financial reporting is outside the scope of the proposal (Board Question 21);
- The Board should clarify the requirements with respect to evaluations of service organizations;
- Outside auditors should be permitted to use the work of others to a greater degree when appropriate (Board Question 12);
- Discretion should be permitted as to the extent of control testing (Board Questions 10 and 11);
- The definitions of significant deficiency and material weakness should be consistent with the definitions of reportable condition and material weakness set forth in current generally accepted auditing standards (Board Questions 17 and 18);
- The Board should consider whether outside auditors are in the best position to evaluate the effectiveness of audit committees given the inherent conflict of interest in such an evaluation (Board Questions 22 and 23); and

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public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals. Industry personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In 2002, the industry generated $222 billion in domestic revenue and $356 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)

2 This letter does not necessarily represent the views of each member of the Securities Industry Association or its Financial Management Division.

- We support the Board's proposed integration of the audit of financial statements with the audit of internal control over financial reporting and the Board's proposal that directs auditors to use their professional judgment to determine whether inadequate documentation constitutes a significant deficiency (Board Questions 2 and 8).

1. <u>The Board Should Clarify that Regulatory Compliance Unrelated to Financial Reporting is Outside the Scope of the Proposal.</u>

Paragraph 126 of the Proposed Standard would provide that for complex entities in highly regulated industries, an ineffective regulatory compliance function should be regarded as at least a significant deficiency and is a strong indicator of a material weakness in internal control over financial reporting. In paragraph 14 of the Proposed Standard, the Board indicates that compliance with laws and regulations directly related to the presentation of and required disclosures in financial statements are encompassed in internal control over financial reporting.

As the Board is aware, the securities industry is highly regulated. Although certain areas in which the industry is regulated, such as trade authorizations, regulatory capital requirements, margin requirements and codes of conduct, may relate to financial reporting, many other areas, such as sales practices, continuing education requirements, trading surveillance and certain recordkeeping requirements, do not directly relate to the financial statements. Requiring independent auditors to assess compliance in all of these areas would not only result in a great deal of effort on the part of auditors due to the wide range of regulations covered, but would also yield little benefit to investors given the lack of relationship between many of these regulations and the financial statements. In that regard, we suggest that the Board clarify that only regulatory compliance directly related to the presentation of and required disclosures in financial statements would be covered by this aspect of the auditing standard. We believe that this approach is consistent with the provisions of the Sarbanes-Oxley Act of 2002 and related rules relating to management's assessment of the effectiveness of internal control over financial reporting. We note that in the adopting release relating to the Securities and Exchange Commission's rules in this area, the SEC states that the definition of internal control over financial reporting does not encompass the elements of the definition set forth in the "Internal Control—Integrated Framework" Report of the Committee of Sponsoring Organizations of the Treadway Commission that relate to regulatory compliance, except where applicable laws and regulations directly relate to the preparation of financial statements.[3]

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[3] The SEC also notes that its definition of internal control over financial reporting is consistent with the definition of internal accounting controls set forth in Section 13(b)(2)(B) of the Securities Exchange Act of 1934.

2. <u>The Board Should Clarify the Requirements with Respect to Evaluations of Service Organizations.</u>

Paragraph 41 of the Proposed Standard would direct an auditor to determine whether management has evaluated the operating effectiveness of controls based on procedures sufficient to assess their operating effectiveness. Examples of such procedures include using a service auditor's report. Paragraph B29 of the Proposed Standard would provide that whenever the company uses a service organization to provide services that are part of the company's information system, the auditor should inquire whether management has received a service auditor's report. According to paragraph B33 of the Proposed Standard, if a service auditor's report on controls placed in operation is unavailable, the auditor might obtain information about the service organization's controls needed to plan the audit from a variety of sources such as user manuals, system overviews, technical manuals and inquiries or observations of personnel at the company or at the service organization, among others. As discussed below, we respectfully request that the Board clarify these requirements.

In particular, we believe the Board should clarify the extent to which service auditors' reports are required and how often the reports must be obtained. Statement on Auditing Standards No. 70, *Service Organizations* ("SAS 70"), provides some guidance as to the level of review and the types of service organizations that should be reviewed during an audit of financial statements. In addition, SAS 70 states that the significance of the controls of the service organization to those of the user organization depends on the nature of the services provided by the service organization, the nature and materiality of the transactions it processes for the user organization and the degree of interaction between the service organization's activities and those of the user organization. We encourage the Board to provide guidance similar to that set forth in SAS 70, as we believe that concepts of materiality of controls of service organizations and "facts and circumstances" determinations are appropriate in order to foster efficient and effective audits of internal control over financial reporting. In particular, we believe that auditors should be permitted to limit their review to those service organizations providing services most likely to have a material impact on the financial statements and similarly should be able to apply a materiality standard in determining the level of testing for a particular service organization.

We also recommend that the Board clarify the procedures to be performed by an auditor once a service auditor's report is obtained. In particular, we suggest that the Board clarify that once the auditor has evaluated the service auditor's reputation, competence and independence and once the auditor has reviewed the report and made the appropriate inquiries of management, if the report provides the information that the auditor needs about the operation of a particular control and if the auditor has tested the user organization's input and output controls relating to the particular organization, no further testing of the control may be necessary.

Finally, we recommend that the Board clarify the procedures to be performed when a service auditor's report is unavailable. For example, in the case of service organizations in non-U.S. jurisdictions, where the SAS 70 standard would not apply and SAS 70 reports are therefore not available, we believe the Board should permit the use of comparable reports under non-U.S. generally accepted auditing standards. In other situations in which reports are unavailable altogether, but only in appropriate circumstances as determined by the auditor, we believe that it should be sufficient that the auditor review the user organization controls over information that is "input" to and "output" from service organizations. In addition, in instances in which management has conducted due diligence to determine whether to use a particular vendor, management has performed ongoing monitoring of that vendor to ensure a high quality of service and an outside auditor has difficulty obtaining technical manuals or directly observing personnel at the service organization, the outside auditor should be permitted to use the information obtained by management in the course of its due diligence and monitoring.

3. Outside Auditors Should Be Permitted to Use the Work of Others to a Greater Degree When Appropriate.

Paragraph 103 of the Proposed Standard would direct auditors to evaluate a number of factors in determining whether to use the results of procedures performed by others. These factors include the materiality or the risk of misstatement of the accounts and disclosures that the controls address and the degree of judgment required to evaluate the operating effectiveness of the controls. We agree with the Board's approach of permitting outside auditors to use the work of others while also cautioning against inappropriate over-reliance on that work. However, as discussed below, we question the appropriateness of the Board's proposal for a blanket prohibition on the use of the work of others in certain areas, including 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.

We understand the Board's concern that there are certain areas in which use of the work of others may be inappropriate. However, taking into account (1) the guidelines already set forth in paragraphs 103 through 110 and Appendix B of the Proposed Standard regarding use of the work of others (including directing outside auditors to evaluate the independence of the internal audit function from management and requiring auditors to perform enough of the testing themselves so that the auditors' own work provides the principal evidence for the audit opinion), (2) the increased focus (through listing standards, among others) on having an internal audit function that reports to the audit committee and (3) the fact that in instances in which an issuer has an internal audit function, the requirements of the Sarbanes-Oxley Act and related rules could result in three levels of review of controls (outside auditors, management and internal auditors), we believe that absolute prohibitions on using the work of others, especially internal auditors, are not necessary to protect investors and are inefficient.

As discussed above, we believe that in keeping with the spirit of the Sarbanes-Oxley Act, the auditing standards under that Act should focus on adding value, in an efficient manner, to investors and other users of financial statements. Investors are harmed not only by ineffective internal controls and misleading financial statements, but also by inefficient use of resources and unnecessary increases in fees paid to service providers resulting from redundant efforts. Therefore, we urge the Board to impose only those requirements that are necessary to protect investors and the integrity of financial reporting.

We encourage the Board to follow the approach set forth in Statement on Auditing Standards No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* ("SAS 65"). SAS 65 provides that if the auditor decides that it would be efficient to consider how the internal auditors' work might affect the nature, timing and extent of audit procedures, the auditor should assess the competence and objectivity of the internal audit function in light of the intended effect of the internal auditors' work on the audit. SAS 65 notes that in making judgments about the extent of the effect of the internal auditors' work on the auditor's procedures, the auditor must consider the materiality of the financial statement amounts, the risk of material misstatement of the assertions related to these financial statement amounts and the degree of subjectivity involved in the evaluation of the audit evidence gathered in support of the assertions. SAS 65 also notes that the degree of reliance on the work of others should be on a sliding scale — as the materiality of the financial statement amounts increases and either the risk of material misstatement or the degree of subjectivity increases, the need for the auditor to perform his or her own tests of the assertions increases; the converse of this statement would also be true. Rather than setting forth blanket prohibitions on the use of the work of internal auditors, SAS 65 allows the auditors to use their professional judgment in determining when and how much reliance should be given to the use of the internal audit function.

We encourage the Board to adopt a similar standard and to permit outside auditors, in appropriate circumstances and as outlined in paragraph 103 of the Proposed Standard, to use the work of others in forming their opinion on the effectiveness of all controls, including information technology general controls.

4. Discretion Should Be Permitted as to the Extent of Control Testing.

Paragraph 27 of the Proposed Standard would require auditors to obtain sufficient competent evidence about the design and operating effectiveness of controls related to *all* relevant financial statement assertions for *all* significant accounts and disclosures in the financial statements. The Board's proposing release setting forth the Proposed Standard (the "Proposing Release") notes that although auditors should vary testing from year to year, each year's audit must stand on its own and therefore, auditors must obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year.

Rather than mandating that evidence be gathered each year for all assertions for all significant accounts and disclosures, auditors should be directed to use their professional judgment to determine not only what accounts and disclosures are "significant" (paragraphs 60-65 of the Proposed Standard) but also to determine when it is appropriate to gather new evidence and when it is appropriate to leverage prior years' evidence. We recommend that the Proposed Standard set forth guidelines in this area. For example, the Proposed Standard could direct auditors to inquire of management as to whether there has been a significant change from the prior year in a control related to a particular financial statement assertion for a particular account. If after performing testing procedures, the extent of which would be determined by the auditor's professional judgment, to validate management's determination, the auditor is satisfied that there has been no such change, and if the auditor otherwise deems it appropriate, the auditor could reasonably rely on prior years' evidence for that particular assertion. We believe that in appropriate circumstances, comprehensive testing of controls can be accomplished without re-testing each particular control on an annual basis; auditors should be permitted to use their professional judgment to determine when re-testing is and is not necessary.

Paragraph 79 of the Proposed Standard would require an auditor to perform a walkthrough for all of the company's significant processes. The Proposed Standard appears to require these walkthroughs to be performed each year. We believe that it is neither efficient nor beneficial to investors to require walkthroughs of *all* significant processes each year. Rather, we believe that the Proposed Standard should permit auditors to use their professional judgment to determine, on an annual basis, the significant processes for which walkthroughs should be performed. We anticipate that by using their professional judgment, auditors will still perform walkthroughs for a substantial portion of a company's significant processes, but that in certain instances, auditors may be able to rotate those significant processes for which walkthroughs are performed. This approach is consistent with the goal of having auditing standards that protect investors while at the same time being efficient and cost-effective. We do not believe that the benefit, if any, to investors of having auditors test *all* financial statement assertions warrants the added costs to companies and investors. Instead, we believe that investors will be benefited most by testing of controls that the auditor determines is sufficient to permit the auditor to reach an opinion on the effectiveness of a company's internal control over financial reporting.

5. The Definitions of Significant Deficiency and Material Weakness Should Be Consistent with the Definitions of Reportable Condition and Material Weakness Set Forth in Current Generally Accepted Auditing Standards.

We believe that the changes made by the Proposed Standard to the definitions of "significant deficiency" and "material weakness" are inadvisable, for the reasons discussed below. Instead, the existing definitions in generally accepted auditing standards should be retained.

The proposed definitions of material weakness and significant deficiency would depart from the definitions set forth in generally accepted auditing standards – AU Section 325, *Communication of Internal Control Related Matters Noted in an Audit* ("AU 325"), and AT Section 501, *Reporting on an Entity's Internal Control Over Financial Reporting* ("AT 501") (incorporating the AU 325 definitions) – and appear generally to lower the threshold for identifying significant deficiencies and material weaknesses.

A significant deficiency under the Proposed Standard would be triggered by any deficiency that results in *more than a remote likelihood* of misstatements of *inconsequential amounts*,[4] whereas under AU 325 it is triggered by any *significant* deficiency that *could adversely affect* reported financial data.[5] Furthermore, the proposed definition would change the threshold for a material weakness to *more than a remote likelihood*, rather than a *relatively low level of risk*.

We have a number of concerns regarding the proposed changes to these definitions. First, the SEC's rules issued in June 2003 relating to management's assessment of internal controls, and conforming changes to management's certifications, appear to incorporate the definitions included in AU 325 and AT 501.[6] If this is the case, we believe that there will be many instances in which

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[4] Paragraph 9 of the Proposed Standard would define "material weakness" to be a significant deficiency that, by itself, or in combination with other significant deficiencies, results in **more than a remote likelihood** that a material misstatement of the annual or interim financial statements will not be prevented or detected. "Significant deficiency" would be defined to be an internal control deficiency that **adversely affects** the company's ability to initiate, record, process or report external financial data reliably in accordance with generally accepted accounting principles. Under the Proposed Standard, a significant deficiency could be a single deficiency, or a combination of deficiencies, that results in **more than a remote likelihood** that a misstatement of the annual or interim financial statements that is **more than inconsequential in amount** will not be prevented or detected.

[5] AU 325 currently defines "material weakness" to be a reportable condition in which the design or operation of one or more of the internal control components **does not reduce to a relatively low level** the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. A "reportable condition" (significant deficiency) under AU 325 is triggered by **significant** deficiencies that **could adversely affect** the entity's ability to initiate, record, process and report financial data consistent with the assertions of management in the financial statements.

[6] Although the SEC's June 2003 adopting release (No. 33-8238) provides that the definitions of material weakness and significant deficiency would have the same meanings as under

management's assessment may not identify a material weakness under the SEC's rules but where the auditors would identify a material weakness under the auditing standards applicable to the auditor's assessment. In this instance, auditors would be required to issue a qualified opinion even though management's assessment complied with the SEC's rules.

Second, even if the SEC were to clarify that its rules incorporate any new definitions of material weakness and significant deficiency, we are more generally concerned with the change in the threshold for identifying material weaknesses and significant deficiencies. We believe that the lower threshold set forth in the Proposed Standard would result in nearly every company having significant deficiencies even though their reporting processes may be functioning in such a manner as would protect investors. We are particularly concerned about the lack of a difference between an internal control deficiency and a significant deficiency and believe that given the low threshold presented by the Proposed Standard, there will be few internal control deficiencies as to which auditors feel confident do not rise to the level of a significant deficiency. Our concern is compounded by the fact that under paragraph 126 of the Proposed Standard, significant deficiencies that have been communicated to management and the audit committee and that remain uncorrected after some reasonable period of time would be regarded as at least a significant deficiency and would be a strong indicator of a material weakness. In addition, under the Proposed Standard, if auditors identify multiple significant deficiencies, none of which are significantly above the threshold, they may believe that they are required to report material weaknesses, even though the probability of one or more of any of these significant deficiencies actually resulting in a material misstatement is very low. We believe that the change in the threshold could have the unintended effect of harming the quality of financial reporting by distracting outside auditors, internal auditors, management and the audit committee into focusing on the deficiencies that have only slightly more than a remote likelihood of failing to detect non-material (but more than "inconsequential" of amount) misstatements of financial statements rather than focusing on more serious deficiencies that, if not corrected, would have a harmful effect on the quality of financial reporting.

Although we recommend that the Board retain the language used in AU 325 and AT 501, if the Board decides to adopt different definitions than those set forth in AU 325 and AT 501, we respectfully request that the Board adopt a "reasonably possible" standard rather than a "more than remote likelihood" standard for both the material weakness and significant deficiency definitions, as those terms are used in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*, or at least clarify that the two phrases establish the same threshold for disclosure to management and the audit committee. We also request that the "inconsequential amount"

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generally accepted auditing standards, the release specifically references AU 325 and AT 501, which may indicate that the SEC intended to incorporate the definitions as in effect at the time of the release.

threshold in the proposed definition of significant deficiency be replaced with a threshold requiring a "significant" misstatement. We believe that an "inconsequential amount" threshold will in practice eliminate the difference between *any* internal control deficiency and a *significant* deficiency. By setting forth a significance test, the standard would clarify the difference between a significant deficiency and an internal control deficiency, while at the same time retaining the distinction between the concepts of material weakness and significant deficiency. Finally, we suggest that the Board clarify that the companies in the examples set forth in Appendix D of the Proposed Standard have no mitigating controls to correct the effect of the identified internal control deficiency, and that that is why the situations lead to conclusions of significant deficiency and material weakness. We believe that in appropriate circumstances, other effective internal controls over financial reporting should be able to compensate for an internal control that is identified to be deficient.

6. The Board Should Consider Whether Outside Auditors Are in the Best Position to Evaluate the Effectiveness of Audit Committees Given the Inherent Conflict of Interest in Such an Evaluation.

Under paragraph 57 of the Proposed Standard, an auditor would be required to evaluate factors relating to the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting. The factors that an auditor would be directed to evaluate would include the independence of the audit committee members from management, the level of involvement and interaction with the independent auditor (including the audit committee's role in the appointment, retention and compensation of the auditor), the audit committee's compliance with applicable listing standards and whether the audit committee includes one or more "audit committee financial experts" as defined by SEC rules under the Sarbanes-Oxley Act. The auditor would also be directed to evaluate how audit committee members are nominated and selected and whether they are selected based upon "desired skill sets".

As provided in the Sarbanes-Oxley Act and as noted in the Proposing Release, that Act makes the audit committee directly responsible for the appointment, compensation and oversight of the work of the auditor. By directing outside auditors to evaluate the committee that has the power to hire and fire the audit firm and the responsibility to oversee and direct their work, the Proposed Standard would create an inherent irreconcilable conflict for the outside auditors which is likely to affect their ability to conduct effectively such a review.

Although we understand the Board's concern about the relationship of the audit committee to the internal control structure, given the inherent conflict discussed above and considering the numerous regulatory requirements imposed on audit committees (*e.g.*, rules promulgated by the SEC, disclosure requirements, applicable listing standards and state law concepts of fiduciary duty), as well as pressure from investors, we believe that mandating auditor review of the audit committee in this manner is neither necessary nor appropriate.

In addition to creating an inherent conflict, many of the determinations that the auditors would be required to make under the Proposed Standard (*e.g.*, whether an audit committee member qualifies as an "audit committee financial expert" and whether the audit committee and its members are in compliance with applicable listing standards) are determinations more appropriately made by the company, usually with the advice of counsel.

We believe that as a matter of general corporate governance, it is the board of directors that is responsible for establishing and maintaining an audit committee that is effective and complies with the relevant rules, including Section 301 of the Sarbanes-Oxley Act. We believe that a separate requirement for evaluation of the audit committee should not be established or implied in the context of Section 404 of the Sarbanes-Oxley Act or the rules and auditing standards related to that part of the Act.

If the Board does retain this concept of auditor evaluation of the audit committee in the final standard, we respectfully request that the Board clarify the qualifications necessary for an auditor to perform this evaluation, including the extent to which the auditor should be familiar with the Sarbanes-Oxley Act and applicable SEC rules and stock exchange listing standards related to audit committees, as well as the manner in which the auditor should gather information required for this evaluation. We also urge that the Board clarify the procedures to be followed in the event that the auditors disagree with a board of directors as to whether a particular audit committee member, or the entire committee, is in compliance with the applicable requirements.

Finally, we recommend that the Board clarify that the required evaluation would apply only to the auditor's evaluation of the audit committee and would not result in management having to conduct a similar evaluation. We believe that, absent clarification, confusion may arise based on the current wording of the Proposed Standard due to the fact that ineffective oversight of external financial reporting and internal control over financial reporting by the audit committee would be considered at least a significant deficiency and would be a strong indicator that a material weakness in internal control over financial reporting exists. If, in light of this provision, auditors take the position that *any* factor that could lead to a significant deficiency should be evaluated by management in order for management's assessment to be adequate, the Proposed Standard could result in auditors expecting management to evaluate the effectiveness of the audit committee in order to receive a "clean" opinion from the auditors. We believe the Proposed Standard should state that such a management evaluation is not required.

7. We Support the Board's Proposed Integration of the Audit of Financial Statements with the Audit of Internal Control Over Financial Reporting and the Board's Proposal that Directs Auditors to Use Their Professional Judgment to Determine Whether Inadequate Documentation Constitutes a Significant Deficiency.

As discussed in the Proposing Release, the Proposed Standard integrates the audit of internal control over financial reporting with the audit of the financial statements. In particular, paragraph 27 of the Proposed Standard states that in order to perform an audit of internal control over financial reporting, the auditor must also audit the financial statements. We agree with the Board that information gathered in the audit of financial statements may be significant to an assessment of internal control. In addition, having the same outside auditors perform both audits will create efficiencies as the auditors will already be knowledgeable about the company's internal control structure through their work on the audit of the financial statements. We support the Board's integrated approach and efforts to create auditing standards that seek to provide guidance to auditors in determining how to use information gathered in an audit of financial statements in an audit of internal control over financial reporting.

We also support the Board's proposal that inadequate documentation of internal control over financial reporting by management should be evaluated to determine whether it rises to the level of a significant deficiency. We believe that auditors are in a position to determine whether inadequate documentation of the design of internal control over financial reporting is so severe as to constitute a significant deficiency. In many instances, inadequate documentation of the design of internal control, by itself, will not rise to the level of a significant deficiency. Rather than setting forth a firm standard, we believe that this determination is better made by auditors who can consider the significance of this deficiency in light of other aspects of a company's internal control over financial reporting.

We would be glad to discuss this letter with representatives of the Board's staff. If you have any questions or require additional information, please call me at 212-272-2000.

Yours truly,

/s/ Marshall J Levinson

Marshall J Levinson
President
Financial Management Division
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