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THE CLEARING HOUSE
Advancing Payment Solutions Worldwide

November 21, 2003

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

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

Ladies and Gentlemen:

The New York Clearing House Association L.L.C., an association of major commercial banks[1], appreciates the opportunity to comment on the proposed auditing standard ("Proposed Standard"), recently published by the Public Company Accounting Oversight Board (the "Board"), for conducting an audit of internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act of 2002 (the "Act").

As financial institutions, we have long recognized that an effective system of internal controls is the essential foundation for sound banking practices, including those relating to financial disclosure and reporting. We believe that requiring independent accountants to play a bigger role in evaluating the effectiveness of internal control over financial reporting can strengthen controls in this area and improve the quality and integrity of financial reporting by public companies. Consequently, we generally support the Proposed Standard.

We have serious reservations, however, about several specific aspects of the proposal that are likely to prove impractical and in some cases unworkable in operation. We believe that the proposal needs to be modified in the ways we describe below. We do not believe that these modifications will weaken the effectiveness of the proposal; on the contrary, by

[1] The members of The Clearing House are Bank of America, National Association, The Bank of New York, Bank One, National Association, Citibank, N.A., Deutsche Bank Trust Company Americas, Fleet National Bank, HSBC Bank USA, JPMorgan Chase Bank, LaSalle Bank National Association, Wachovia Bank, National Association, and Wells Fargo Bank, National Association.

eliminating those aspects of the Proposed Standard that are likely to create significant practical problems for public companies, we think our suggested changes will promote compliance with the standard and advance the broad purposes of Section 404 of the Act.

(1) The Final Rule Should Permit Auditors Greater Flexibility in Relying on the Work of Others and in Conducting Control Testing and Walkthroughs

By requiring an audit of internal control over financial reporting, rather than merely an attestation regarding management's assessment of those controls, the Proposed Standard goes well beyond the requirements of Section 404 of the Act. If auditors will be required to conduct an audit of those controls, they should be given considerable flexibility in determining the appropriate scope of the audit, just as they are with regard to an audit of financial statements. Given the breadth and complexity of the work that may be required to conduct an audit of those controls in any particular case, we believe it is critical that auditors be permitted to exercise their professional judgment, based on their knowledge of the relevant facts and circumstances, in planning and conducting the audit and, in particular, in determining the extent to which they may rely on the work of others and the extent to which they must conduct control testing and walkthroughs.

We think this flexibility is especially appropriate in light of the significant new reforms enacted this past year with regard to public company financial reporting and disclosure. The SEC's new rules under Section 404 of the Act will require management to dedicate significant resources to periodic assessments of internal control over financial reporting. In addition, new SEC and stock market rules encourage both audit committees and internal auditors to play bigger roles in monitoring the effectiveness of internal control over financial reporting. Prohibiting auditors from relying on broad categories of work performed by management and internal auditors in all cases, without allowing auditors to exercise their professional judgment about the extent to which they should duplicate this work in light of the specific facts and circumstances, is excessive and is likely to result in needless and costly duplication of effort, especially in light of these new regulations. We have similar concerns about requiring auditors to conduct control testing and walkthroughs without being able to use their discretion in determining the appropriate scope and frequency of these procedures.

Relying on Work of Others. We do not believe the Proposed Standard should prohibit auditors from relying on the work of others in the areas identified in Paragraph 104 of the proposal in all cases. A blanket prohibition with respect to these areas would be inappropriate for the reasons discussed above. Auditors should instead be permitted to exercise their professional judgment — as contemplated in Paragraph 103 of the Proposed Standard — in determining whether to rely on another party's work with respect to each control that must be audited.

Requiring auditors to duplicate the efforts of management and internal audit across the board for all companies is especially unwarranted with regard to insured depository institutions and bank holding companies, such as our members. These companies are required under the Federal Deposit Insurance Corporation Improvement Act of 1991 to produce annual internal control reports, attested by independent auditors, assessing the effectiveness of internal controls. In response to this requirement, insured depository institutions and many bank holding companies have developed sophisticated and reliable internal systems for monitoring the effectiveness of internal controls. We believe that prohibiting auditors from using their discretion to determine whether and to what extent reliance on these existing systems may be appropriate, at least in some areas, will subject these institutions to significant additional expense that is likely to yield little or no improvement in the reliability of these controls.

We believe the Board should follow the approach set forth in SAS 65[2], which permits the auditor take into account the work of internal auditors in certain circumstances. SAS 65 allows the auditor to make judgments about the degree to which it may rely on internal auditors' work, provided that the auditor makes an assessment of the competence and objectivity of the internal audit function, and of the materiality and degree of subjectivity relating to the particular financial amounts in issue. Rather than imposing a blanket prohibition on the use of internal auditors' work, SAS 65 allows auditors to use their professional judgment in determining when and to what extent they should rely on the internal audit function. Reliance on the work of others may be inappropriate in some areas but not necessarily in all areas for all companies. In addition, by limiting an auditor's ability to rely on work performed by the internal audit function, the Proposed Standard could have the unintended effect of reducing the importance of the internal audit function, a result that would be contrary to Act's goal of promoting strong and effective internal control over financial reporting.

Principal Evidence for Audit Opinion. Closely related to the issue of auditors' reliance on the work of others is the requirement in Paragraph 109 of the Proposed Standard that the auditor's own work provide the "principal evidence" for the audit opinion. This requirement is both difficult to apply and potentially very burdensome. Without further clarification, it is unclear by what metric – such as hours worked, number of controls reviewed or importance of controls – auditors should determine whether their own work constitutes principal evidence. Regardless of the metric used to measure the relative amount of work performed by the auditor, it would be time consuming and expensive to require auditors to perform a majority of the work required for an audit. This is particularly true for large, multinational financial institutions that maintain extensive systems of internal controls. While we agree that there should be *qualitative* restrictions on an auditor's ability to rely on others' work, we do not think there should be a *quantitative* test that would require the independent auditor to perform a specified volume of work.

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[2] Statement on Auditing Standards No. 65, *The Auditor's Consideration of the Internal Audit Functions in an Audit of Financial Statements.*

Control Testing and Walkthroughs. For the reasons set forth above, we believe that Paragraphs 27 and 74 of the Proposed Standard, relating to control testing, and Paragraph 79, relating to walkthroughs, should be modified to allow auditors to use their professional judgment in determining the extent and frequency of their testing and walkthrough activity. Paragraphs 27 and 74 requires an auditor to gather sufficient competent evidence for *all* assertions for *all* significant accounts and disclosures in the financial statements, presumably *every* year. We think auditors should be directed to use their professional judgment to determine not only what accounts and disclosures are significant but when it is appropriate to gather new evidence or use the prior year's evidence. Similarly, we do not think it is necessary or helpful to investors to require an auditor to perform a walkthrough of *all* significant processes of a company *every* year, as Paragraph 79 appears to require. We think the Proposed Standard should be revised to make it clear that an auditor must conduct control testing and walkthroughs to the extent that it determines is sufficient to enable it to form an opinion about the effectiveness of a company's internal control over financial reporting.

(2) The Definition of "Material Weakness" Should not Be Broader than the Definition Recognized by the SEC, and "Significant Deficiency" Should Be Limited in a Consistent Manner

The Proposed Standard would preclude an auditor from giving an unqualified opinion if it identified a "material weakness," which would be defined as any significant deficiency that results in *more than a remote likelihood*[3] that a material misstatement of the annual or interim financial statements will not be prevented or detected. We believe this definition sets far too low a threshold for what constitutes a material weakness. The concept of "remote" is extreme, and we are concerned that it may be interpreted as referring to any event whose likelihood of occurring is only slightly more than non-existent. Given the serious consequences for auditors who are judged in hindsight as having taken too lax an approach in this area, we think auditors will naturally choose to err on the side of caution when applying this concept, leading them to regard as a material weakness many conditions whose likely impact on the financial statements is little more than theoretical. We agree that the threshold for material weakness should be lower than "probable" or "more likely than not." However, the range of probabilities between this threshold and the "remote" threshold is simply too wide. We think the appropriate threshold lies somewhere in the middle of this range.

The new SEC rules under Section 404 of the Act prohibit management from concluding in its annual internal control report that internal control over financial reporting is effective when one or more material weaknesses exist. In its adopting release for these rules, the SEC defined material weakness by reference to current accounting literature, as a "reportable

[3] "Remote likelihood" would have the same meaning as the term "remote" used in Financial Accounting Standards Board No. 5, *Accounting for Contingencies*, which states that "remote" means the chance of a certain future event or events occurring is slight.

condition" in which the design or operation of one or more internal control components does not reduce the risk of misstatement to a *relatively low level*.[4] We think the SEC's interpretation appropriately targets the middle ground between "remote" and "probable." We urge the Board to take a similar approach, and to define material weakness as a significant deficiency that is *reasonably likely* to result in a material misstatement. We do not think that the definition of material weakness will be workable unless the Board makes clear that there must be some reasonable likelihood that a material misstatement may occur.

The proposed definition of "significant deficiency" raises similar problems. "Significant deficiency" would be defined as an internal control deficiency or a combination of such deficiencies that results in *more than a remote likelihood* that a financial misstatement of *more than an inconsequential amount* will not be prevented or detected. For the reasons described above, we think the concept of "remote" sets far too low a threshold. We think the concept of "more than an inconsequential amount" does so as well. With these low thresholds, there would be no meaningful distinction between a deficiency that is significant and one that is not. In defining "significant deficiency," we believe the Board should replace "remote" with "reasonably likely" and should replace "inconsequential" with a "significance" standard. In other words, a "significant deficiency" should be defined as an internal control deficiency or a combination of such deficiencies that is reasonably likely to result in a significant financial misstatement not being prevented or detected.

(3) The Proposed Standard Should Clarify the Scope of an Auditor's Duty to Evaluate the Effectiveness and Independence of the Audit Committee

Paragraphs 57 and 58 of the Proposed Standard would require an auditor to evaluate the effectiveness and independence of the audit committee, which under the new SEC and stock market rules is responsible for hiring the auditor, fixing its compensation and overseeing its work. Requiring an auditor to pass judgment on its overseers creates a significant conflict of interest for the auditor (and perhaps for the audit committee). While we agree that an effective audit committee is an important element of internal control over financial reporting and that some level of review of this element by an auditor is appropriate, we think the scope of that review needs to be clearly delineated to ensure that the inherent conflict of interest remains

[4] See *Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, Release No. 34-47986 (June 5, 2003), 68 Fed. Reg. 36,636 (June 18, 2003), available at http://www.sec.gov/rules/final/33-8238.htm. The adopting release references AU Section 325 and AT Section 501, which define "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. While AU Section 325 and AT Section 501 may be superseded by the Board's Proposed Standard, we think the SEC's approach in this area is persuasive.

manageable for an auditor and does not undermine the audit committee's auditor-oversight role. The Proposed Standard should clarify that an auditor's review of the audit committee's functions should focus on its structural and procedural aspects and not on the personal qualifications of the audit committee members.

We think it is appropriate to require an auditor to review the structural and procedural aspects of the audit committee function – that is, to determine whether the audit committee has appropriate access to and interaction with the internal auditors and those members of management responsible for financial reporting, is given enough information about the company's internal control over financial reporting so as to understand how it operates and what its strengths and weaknesses are and generally is provided adequate administrative and professional support. However, requiring the auditor to evaluate the personal qualifications of individual audit committee members –their independence and financial expertise – has the potential to create a serious and unmanageable conflict of interest.

In particular, the audit committee should not be required to make an affirmative, de novo determination of whether an audit committee member meets the independence standards under SEC and stock market rules. Applying these standards requires a significant degree of business judgment and legal analysis, and the responsibility for applying them is properly reserved for the company and its board of directors in consultation with its attorneys. Requiring an auditor to make its own determination about the independence of an audit committee could lead to highly disruptive second guessing of the company and its board, would require the auditor to make judgments beyond its expertise and could bring the auditor into direct conflict with the audit committee.[5] For the same reasons, we do not think an auditor should be required to evaluate the financial expertise of audit committee members, including any member identified by the company as a financial expert.

In sum, we urge the Board to provide clear guidance about which aspects of the audit committee function an auditor is and is not expected to evaluate. The Proposed Standard should make clear that this evaluation is to focus on structural and procedural aspects of the kind described above and not on the personal qualifications, including the independence and financial expertise, of the audit committee members.

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[5] If an auditor learns about a relationship between an audit committee member and the company that could significantly impair the member's independence and has not been publicly disclosed, it may be appropriate to require the auditor to discuss the relationship with the company and the audit committee. Requiring an auditor to raise questions about material facts relating to independence that may come to its attention is very different, however, from requiring it to make a de novo determination about whether the audit committee member is independent.

(4) The Proposed Standard Should Provide Guidance About Bring-Down Procedures for Audit Report and Consent Filings

Paragraph 181 of the Proposed Standard would require auditors to perform bring-down procedures in accordance with AU Section 711 with respect to the filing of an audit report on management's assessment of internal controls. The Proposed Standard would direct auditors to inquire of and obtain written representations from executives responsible for financial accounting matters about whether any events have occurred that have a material effect on management's assessment of internal control over financial reporting. We are concerned that this provision could be interpreted to require management and auditors to perform costly and time-consuming evaluations of changes in internal control that take place at any time *after* the close of the relevant reporting period and up to the relevant filing date. This could require management and the auditor to review every change in internal control over financial reporting since the report period to determine whether any of them have had or could have a material effect on those controls. We urge the Board to clarify that the required bring-down procedures apply only to developments that are relevant to the effectiveness of those controls as in existence during the report period. Alternatively, if these procedures are to apply to developments relevant to these controls as in effect after the report period, then procedures should apply only to those developments having a material *adverse* effect on these controls. Clarifying the scope of the required bring-down procedures is particularly important with regard to the filing of auditor consents (*e.g.,* relating to registration statements), which can occur many times throughout the fiscal year and on relatively short notice. We believe that clarification of this kind is especially necessary for large, multinational financial institutions that maintain extensive systems of internal controls and must modify and update those systems on a regular basis.

(5) The Circumstances Listed in Paragraph 126 Should Not Be Presumed to Reflect Significant Deficiencies or to Be Strong Indicators of Material Weaknesses in All Cases

Paragraph 126 of the Proposed Standard would require auditors to regard a number of different circumstances listed in that paragraph as significant deficiencies and "strong indicators" that a material weakness may exist. While any one of these circumstances might be attributable to a significant deficiency or material weakness in internal control over financial reporting in some cases, mandating a presumption that all of them are so attributable in all cases would be inappropriate. For example, the Proposed Standard would require auditors to regard any material misstatement in a current period not initially identified by a company's internal control over financial reporting as a significant deficiency and "a strong indicator" that a material weakness may exist. While some current-period audit adjustments may in fact be attributable to significant deficiencies or material weaknesses in internal control over financial reporting, a presumption that all such adjustments are likely to be is overly broad. Audit adjustments are often made to items requiring a significant degree of judgment about factors that are not known or measurable and thus arise because of differences of opinion between management and the auditor, not because of a breakdown in internal control. This is particularly true for valuation of financial instruments and other assets for which no ready market exists, as well as for assessments about the probability and potential magnitude of contingent liabilities such as those arising from pending litigation or complex contractual arrangements.

The other items listed in Paragraph 126 may also, in some cases, be attributable to significant deficiencies or material weaknesses. In other cases, however, auditors may be able to determine that one or more of these items are unrelated to any significant deficiency or material weakness in internal control. In addition, the vagueness of some of the items – such as the existence of an "ineffective regulatory compliance function" – could lead to overly broad application of the presumption. Rather than imposing an across-the-board presumption, the Proposed Standard should permit auditors to use their professional judgment in determining whether any of these items is attributable to a significant deficiency or material weakness in internal control over financial reporting in any particular case.

For the reasons set forth above, we do not think it is appropriate to include a list of any specific circumstances that should be presumed to reflect a significant deficiency or considered a strong indicator that a material weakness exists. We believe the list of circumstances in Paragraph 126 should be deleted.

(6) Audit Committees Should Not Be Required to Pre-Approve All Non-Audit Services Relating to Internal Controls

The SEC's new auditor independence rules require that any non-audit service provided by an auditor to an issuer or its subsidiaries either be specifically pre-approved by the issuer's audit committee or fall within a clearly defined category of services that has been pre-approved by the audit committee. While the SEC staff has cautioned against pre-approval of broad, vaguely defined categories of services, it recognizes that categorical pre-approval is permitted if the categories are sufficiently well defined and appropriately limited in scope.[6] Under the Proposed Standard, in contrast, audit committees would not be able to pre-approve any non-audit services relating to internal controls on a categorical basis and instead would have to specifically pre-approve each of those services.

We believe the SEC's approval policy strikes an appropriate balance between the need to give management sufficient flexibility to address internal control issues as they arise and the need to ensure adequate auditor oversight by the audit committee. Striking a balance between these two needs is especially important for large, multinational financial institutions,

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6 See *Office of the Chief Accountant: Application of the January 2003 Rules on Auditor Independence Frequently Asked Questions*, available at http://www.sec.gov/info/accountants/ ocafaqaudind080703.htm (August 13, 2003).

which maintain extensive, complex systems of internal control that must be continuously monitored and frequently updated to reflect changes in the many different business practices they are designed to control. We do not think the Board should impose a pre-approval rule for internal control-related services that differs from the SEC's rule for non-audit services generally. We think the Proposed Standard should be revised to allow categorical pre-approval of audit services relating to internal control, consistent with the SEC's auditor independence rules. In particular, the Board should make it clear that an audit committee may pre-approve services to be rendered in connection with the annual audit of internal control over financial reporting on a categorical basis, and should not have to specifically pre-approve each aspect of these services that might be rendered throughout the annual audit cycle.

(7) The Proposed Standard Should Provide Guidance Regarding Business Combinations Consummated Late in the Audit Cycle

Companies that combine by merger, acquisition or other transactions may have very different systems of internal control over financial reporting. Often, these systems must be integrated into a single, comprehensive system through a lengthy process involving modification of technology and operating systems, retraining of personnel and documenting the changes. If a combination occurs late in the surviving company's annual audit cycle, its management and auditors may not have enough time to become familiar with the different internal control systems used by the acquired company, much less with any comprehensive system to be formed through the integration process, before an audit of the annual financial statements for the combined company is required to be completed. In these circumstances, it may not be possible to evaluate internal control for the combined company without relying on the work of management and the auditor for the acquired company. It may not even be possible to provide a single, comprehensive evaluation for the combined company as a whole; separate evaluations of the constituent companies by their respective management teams and auditors may be the only feasible approach. Accordingly, we urge the Board to provide guidance to management and auditors of surviving companies of business combinations consummated late in an audit cycle, indicating the extent to which they may rely on work performed by management and auditors of the constituent companies, including separate evaluations of the effectiveness of those companies' controls. An example of constructive guidance in this area would be to permit auditors to issue "except for" opinions in connection with business combinations effected late in the audit cycle. In these situations, an auditor simply may not have time to complete the necessary work regarding all relevant aspects of an acquired company's internal controls. We believe that the auditor should have the latitude to issue an "except for" opinion in these situations with regard to all or part of the internal controls of the acquired company.

(8) **The Proposed Standard Should Provide Guidance Regarding Evaluations of Service Organizations**

The Proposed Standard directs auditors to obtain information regarding the controls maintained by service organizations with regard to the services they provide to a company as part of the company's information system. Auditors may obtain information from a service auditor's "report on controls placed in operation" pursuant to AU Section 324; if a service auditor's report is not available, the auditor may obtain information from other sources, including user manuals and the contract between the company and the service organization. We urge the Board to clarify these requirements, particularly the extent to which and how often service auditors' reports will have to be obtained, the extent of procedures that must be performed when a service auditor's report is unavailable and the extent to which auditors may rely on service auditors' reports. We think SAS 70[7] provides useful guidance on these matters with regard to audits of financial statements. Among other things, 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 believe that guidance similar to that contained in SAS 70, which has been in effect for many years and is already familiar to those in the financial services industry, would be appropriate in the context of audits of internal control over financial reporting. We think that SAS 70's reliance on concepts of materiality and the auditor's exercise of professional judgment based on particular facts and circumstances are especially appropriate in this context.

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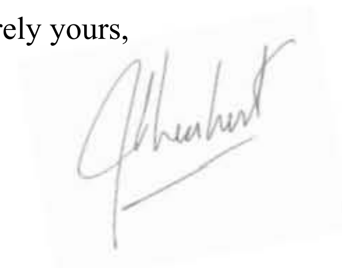
We recognize that the Board faces a number of difficult challenges in developing the Proposed Standard and in fulfilling its overall mandate to the investing public. We welcome the opportunity to comment on the proposal, and we would be pleased to meet with the Board or its staff to discuss our comments if that would be helpful. If you have any questions about our comments or would like to discuss them with us, please contact Norman R. Nelson, General Counsel of The Clearing House, at 212-612-9205.

Sincerely yours,



[7] Statement on Auditing Standards No. 70, *Service Organizations* ("SAS 70").