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Business Law Section
Committee on Securities Regulation

November 25, 2003

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

E-mail address: comments@pcaobus.org

Re: PCAOB Rulemaking Docket Matter No. 008
Proposed Auditing Standard - An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements
PCAOB Release No. 2003-017, October 7, 2003

Ladies and Gentlemen:

The Securities Regulation Committee of the Business Law Section of the New York State Bar Association appreciates the invitation in PCAOB Release No. 2003-017 (the "Release") to comment on auditing standard ("Proposed Standard") proposed by the Public Company Accounting Oversight Board (the "Board") under Sections 103(a)(2)(A) and 404(b) of the Sarbanes-Oxley Act of 2002 (the "Act").

The Committee on Securities Regulation (the "Committee") is composed of members of the New York Bar, a principal part of whose practice is in securities regulation. The Committee includes lawyers in private practice and in corporation law departments. A draft of this letter was reviewed by certain members of the Committee, and the views expressed in this letter are generally consistent with those of the majority of members who reviewed and commented on the letter in draft form. The views set forth in this letter, however, are those of the Committee and do not necessarily reflect the

views of the organizations with which its members are associated, the New York State Bar Association, or its Business Law Section.

A. Summary of Comments

The Committee supports the efforts of the Board to establish a standard for attestation engagements of auditors regarding the internal control over financial reporting. We recognize the steps the Board has taken to obtain input from various stakeholders before issuing the Proposed Standard. Our comments reflect that the Committee is composed of attorneys who advise on the securities laws, corporate governance and disclosure, and represent a broad range of large, small and medium-sized domestic companies and foreign private issuers of all sizes.

Paragraphs 56 through 59[1] of the Proposed Standard would require the auditor to evaluate the effectiveness of the audit committee and to conclude there is at least a significant deficiency and strong indicator of a material weakness in internal control, if the auditor finds ineffective oversight by the audit committee. We believe that such an evaluation would involve an inherent conflict-of-interest, and that auditors are not in a good position to make the judgments as to the effectiveness of audit committees. Accordingly, we urge the Board to delete Paragraphs 56 through 59.

We appreciate the Board's recognition that internal control is not "one-size-fits-all." We recommend that the Board insure that this concept in embedded in the rules by expressly directing in the Proposed Standard that auditors exercise their judgment to determine whether modifications or alternatives to the procedures and requirements of the Standard would be appropriate for small and medium-sized companies, foreign private issuers, and generally to reflect the diverse group of larger companies. It would also be helpful to define what constitutes a small and medium-sized company. In addition, we recommend that the Board separately seek comments on the issues uniquely faced by foreign private issuers. We note that the implementation schedule would permit time to conduct such a review without delaying application of the Proposed Standard to domestic issuers.

The Act and the rules adopted by the Securities and Exchange Commission to implement the Act do not provide a role for the auditor with respect to changes in the internal control made during fiscal quarters. Whatever rules the Board ultimately adopts for quarterly periods, we urge the Board to delete or modify Paragraphs 184 through 189 so that the Proposed Standard would not require auditor action in the case of disagreements with management regarding the disclosure of changes in internal control. As proposed, the auditor would be required to report up-the-ladder and consider resignation if the auditor disagreed with the adequacy of the company's disclosure of the reasons and circumstances for making a change in internal control and concluded that the audit committee did not respond appropriately to the auditor's view, even in the case where no significant deficiency or material weakness in internal control would result.

[1] All references to "Paragraphs" are to the numbered paragraphs in the "Appendix - Proposed Auditing Standards.

Finally, the Release and Proposed Standard cite Section 10A of the Securities Exchange Act of 1934 and AU Sections 317 and 722 of the generally accepted auditing standards adopted by the Board on an interim basis as support for imposing these quarterly period requirements. However, those provisions apply to illegal acts and material misstatements in financial statements. We believe that those provisions do not validly apply to a deficiency or weakness in internal control by itself, and that reference to those provisions should be deleted from the Proposed Standard as finally adopted.

B. <u>The Proposed Evaluation Of The Audit Committee's Performance Would Be Ineffective, Would Involve An Inherent Conflict-Of-Interest, And Should Be Eliminated (Related Questions: 22, 23,and 24)</u>

Section 404(a) of the Act requires the management of a public company to assess the effectiveness of the company's internal control over financial reporting. Sections 103(a)(2)(A) and 404(b) of the Act direct the Board to establish professional standards governing the independent auditor's attestation and reporting on management's assessment of the effectiveness of internal control over financial reporting.

The Proposed Standard (Appendix A, paragraphs 56 to 58) would require that the auditors, as part of the review necessary to deliver the attestation, evaluate the effectiveness of the audit committee in performing a number of roles within the control environment regarding financial reporting. As part of that analysis, the auditor would be called upon to evaluate the independence of the audit committee, among other factors. By way of example, Paragraph 57 requires the auditors to evaluate the level of involvement and interaction of the audit committee with the independent auditor, including "the committee's role in the appointment, retention, and compensation of the independent auditor." Paragraph 59 provides that, if the auditor determines there is ineffective oversight by the audit committee, that would be at least a significant deficiency and a strong indicator that a material weakness exists.

Question 23 of the Release asks whether the auditors will be able to carry out that responsibility effectively. We believe that the auditors will not be able to carry out that responsibility effectively because of an inherent conflict-of-interest -- the auditors would be responsible for reviewing the effectiveness of the same audit committee that is responsible for the appointment, compensation and oversight of the auditors themselves under Section 301 of the Act. We believe that in essence this results in a circular set of circumstances in which someone who reports to the audit committee itself is reviewing the audit committee. Requiring the auditor to evaluate the audit committee would not only create a conflict of interest between the auditor and the audit committee, but would seem to constitute an anomaly as regards the Board's rules on independence.

One of the Act's main concerns is auditor independence. Title II of the Act seeks to ensure that the auditors be retained and supervised by independent persons in the form of the independent audit committee, and not by senior management whose determinations and actions the auditors, *inter alia*, review.

Consequently, we believe that it violates the spirit of the Act and the principles laid down in the Proposed Standard to task the auditors with the review of the audit committee's effectiveness.

In addition, a review by the auditors of the audit committee would fail the independence test the Board itself has provided in Paragraph 32 that the independent auditor must not function in the role of management. It seems to us that the evaluation of the effectiveness of a board committee is necessarily a responsibility of the board of directors, and not the independent auditor.

Finally, we question whether the auditors are in a good position to make the judgment as to the effectiveness of the audit committee. For the auditor to attempt to reach a conclusion on effectiveness, the PCAOB would first have to adopt clear standards by which an auditor could reach such a conclusion. In addition, as a matter of corporate governance, the board of directors are charged with and are more competent to deal with the composition and size of a board committee, the frequency of committee meetings, and other aspects of the audit committee. For example, there are many considerations that go into an evaluation of a board committee, such as the quality and timeliness of the committee's reporting to the full board of directors, which are not within the purview of the auditors. Furthermore, the auditor will always be at a disadvantage since the auditor cannot know the level of activity and discussion by the audit committee when the auditor is not present.

For the reasons above, we urge the Board to revise the Proposed Standard to remove the review of the audit committee by the auditors and the related conclusions by deleting Paragraphs 56 through 59.

C. The Proposed Standard Should Direct Auditors To Exercise Their Judgment To Determine When To Apply Modifications Or Alternatives To The Specific Requirements And Procedures Of The Standard (Related Question: 4)

We appreciate the Board's sensitivity to the possible effects of the Proposed Standard on small and medium-sized companies and welcome the Board's position that internal control is not "one-size-fits-all." However, we believe that the specificity of the Proposed Standard does not allow sufficient room for the auditor to exercise reasonable professional judgment, in particular for small and medium-sized domestic issuers and foreign private issuers of any size.

1. Small and Medium-Sized Domestic Issuers

The Committee endorses Appendix E "Special Internal Control Over Financial Reporting Considerations for Small and Medium-Sized Companies." The current draft of the Proposed Standard, however, is unclear as to how the principles laid down in Appendix E apply within the rules established in the specific Paragraphs of the Proposed Standard.

Although Paragraph 14 refers to Appendix E when discussing special considerations for accommodating small and medium sized domestic issuers, the Proposed Standard should expressly incorporate Appendix E and direct the auditors to consider the principles in Appendix E to ascertain whether or not specific requirements and procedures of the Proposed Standard are required. It would be helpful if the Board would define the criteria for determining the small and medium sized companies for which Appendix E is applicable. By way of example, in establishing the effective dates for Section 404 certifications regarding internal control, the Securities and Exchange Commission established a category of accelerated filers in contrast to other filers. This would result in some of the procedures and evaluations expressed as "must," "shall," and "is required" becoming optional subject to the judgment of the auditor when a particular requirement is applied to a small or medium-sized company.

2. Other Domestic Issuers

The Board should similarly expressly provide in the Proposed Standard that the auditors can apply the principles in Appendix E in their judgment to determine whether modifications or alternatives to the procedures and requirements of the Proposed Standard would be appropriate in the case of larger companies. This would permit auditors flexibility in the review of larger companies and the ability to use their professional judgment in determining how to approach the diverse group of issuers they encounter.

3. Foreign Private Issuers (of any size)

While Appendix E contains guidance with respect to auditing standards for smaller companies, the Proposed Standard contains no such guidance for foreign private issuers, be they small or large. As a consequence, foreign private issuers appear to be subject to the Board's detailed rules, custom-tailored for American corporations. We note that many important foreign jurisdictions have a more principles-based approach to corporate governance, auditing and accounting. These standards will be difficult to reconcile with the highly specific standards proposed by the Board.

Board Chairman McDonough emphasized the Board's openness to international cooperation and its readiness to accommodate the needs of foreign issuers (in particular, when local law directly conflicts with the Board's rules) in a speech at "The Fourth Annual A.A. Sommer, Jr. Corporate Securities & Financial Law Lecture" at Fordham Law School on November 11, 2003. The Securities and Exchange Commission also has moved forward in this area and seeks to accommodate or even adopt a more principles-based approach to accounting. However, the Proposed Standard unfortunately follows a mostly rule-based approach.

We believe that the Board should consider the effect of the Proposed Standard on foreign private issuers, and attempt to better understand problems foreign issuers may have in applying the Proposed Standard and the areas in which foreign private issuers require flexibility. In addition, foreign private issuers may also be subject to conflicting

regulation which should somehow be accommodated. If that is not done, the cost of complying with rules in two jurisdictions could drive dually listed issuers from the U.S. markets, especially given how expensive compliance with the U.S. rules alone will be.

We recommend that the Board proactively seek the comments of foreign accounting firms, foreign private issuers and its sister agencies in important foreign jurisdictions, and give these parties more time to react to the Proposed Standard. Because there is an additional year before auditors must apply the Proposed Standard to foreign private companies, this should not delay adoption of the Proposed Standard for domestic companies while allowing additional time to customize the Proposed Standard for foreign private issuers.

D. Reporting Up-The-Ladder And Consideration Of Resignation By Auditors Should Not Be Required For Perceived Disclosure Deficiencies Regarding Reasons For Quarterly Changes In Internal Controls (Related Questions: 30 and 31)

Paragraphs 183-189 provide that, if during the course of limited interim quarterly procedures for reviewing internal controls or reviewing changes during the fourth quarter, the auditor becomes aware that the disclosures by management about changes in internal control do not disclose the reasons for the changes and the auditor believes such disclosure is necessary, the auditor would be required to communicate the matter initially to management. If management failed in the auditor's judgment to respond appropriately, the auditor would be required to communicate to the audit committee and if the audit committee failed to respond appropriately, the auditor would be required to evaluate whether or not to resign from the engagement.

However, what the role of the auditor should be during quarterly periods, including the fourth quarter of the fiscal year, as well as the authority for the Board to establish any requirements on a quarterly basis, is problematic. Section 404 of the Act requires the auditor to attest to, and report on, the assessment by management regarding the internal control structure and procedures for financial reporting, but only applies to reporting on the fiscal year in the annual report.

Specifically, Section 404(a) of the Act requires, by Commission rulemaking, each annual report to contain an internal control report consisting of an assessment by management as of the end of each fiscal year of the effectiveness of the internal control structure and procedures of the issuer for financial reporting. Section 404(b) requires, with respect to the internal control assessment required by subsection (a), each auditor preparing or issuing an audit report to attest, and report on, the assessment made by management

Section 302 of the Act, on the other hand, does apply to reports for fiscal quarters with respect to internal controls, but does not provide for any report or attestation by the auditors. The Rules adopted by the Securities and Exchange Commission require that certifying officers in both the quarterly reports and the annual report certify that material changes in internal control over financial reporting during the quarter (fourth quarter in

the case of the annual report) have been disclosed in the report, but do not require attestation or any other action by the auditor.

Moreover, the Commission, in adopting the quarterly requirement with respect to management, expressly did not require management to disclose the reason for any change in the internal control that occurred during the quarter. The Commission noted in the adopting Release that

> "Although the final rules do not explicitly require the company to disclose the reasons for any change that occurred during a fiscal quarter, or to otherwise elaborate about the change, a company will have to determine, on a facts and circumstances basis, whether the reasons for the change, or other information about the circumstances surrounding the change, constitute material information necessary to make the disclosure about the change not misleading." (Release No. 33-8238)

In accordance with the Commission's apparent reliance on the anti-fraud rules under Rules 10b-5 and 12b-20, management must make an assessment whether or not to disclose the reasons for a change in its internal controls or other facts and circumstances surrounding the change. This much is already required in order to comply with Rule 10b-5. However, the Proposed Standard would push the auditor's responsibility into this area of management judgment even where there is no misstatement in the financial statements and no existing significant deficiency or material weakness in the internal control.

Finally, as a matter of policy, we believe that the Proposed Standard should encourage management's timely identification and correction of material weaknesses prior to the end of the fiscal quarter in question. In such a case, management could correctly certify that the company's internal control for financial reporting was effective as of the end of the period. The adoption of proposed Paragraphs 187 and 188 is not warranted -- it could raise the mandated disclosure bar and would not serve to encourage management and issuers to find and correct material weaknesses during a fiscal quarter.

Whatever audit rules the Board may ultimately adopt with respect to changes in internal control during any fiscal quarter (including the fourth quarter), such rules expressly should not impose any requirement on the auditors with respect to management's disclosure of reasons for changes made during the quarter in internal control. Accordingly, we urge the Board to delete or modify Paragraphs 184 through 189 so that the Proposed Standard would not require auditor action in the case of disagreements with management regarding the disclosure of changes in internal control. Of course, as always, the auditors in the exercise of their judgment can communicate any particular information to management or the audit committee, and take whatever action they believe is appropriate with respect to any difference of opinion they may have with management or the audit committee.

E. Section 10A Of The Exchange Act And AU Sections 317 And 722 Do Not Provide A Valid Basis For Adopting Rules Regarding Changes In Internal Control During Fiscal Quarters (Related Questions: 30 and 31)

As discussed above, we question what the basis of authority would be for the Board to adopt requirements with respect to changes in internal control during a fiscal quarter. The Release and Paragraphs 183-189 attempt to assert a basis for such proposed rules described in Part D above, by reference or analogy to Exchange Act Section 10A and AU Sections 317 and 722 of the generally accepted auditing standards adopted on an interim basis in PCAOB Rule 3200T. However, those sections cover illegal acts and material misstatements in financial statements. We believe that there is no basis in fact or law for making the leap from a deficiency or weakness in internal control or the absence of a disclosure about why a material change was made in internal control to an illegal act or a material misstatement in the financial statements.

We hope the Commission finds these comments helpful. We would be happy to meet with the Staff to discuss these comments further.

Respectfully submitted,

COMMITTEE ON SECURITIES REGULATION

By /s/Michael J. Holliday
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