File No. PCAOB-2004-03
Consists of 1,877 Pages

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 19b-4

Proposed Rules

By

Public Company Accounting Oversight Board

In accordance with Rule 19b-4 under the
Securities Exchange Act of 1934

1. Text of the Proposed Rule

(a) Pursuant to the provisions of Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") is filing with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule, Auditing Standard No. 2, “An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements.” The proposed rule consists of an auditing standard applicable to audits of internal control over financial reporting of issuers by registered public accounting firms and five appendices containing example reports and additional guidance. The proposed rule is attached as Exhibit A to this rule filing.

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Board

(a) The Board approved the proposed rule, and authorized it for filing with the SEC, at its Open Meeting on March 9, 2004. No other action by the Board is necessary for the filing of this proposed rule.

(b) Questions regarding this rule filing may be directed to J. Gordon Seymour, Deputy General Counsel (202-207-9034; seymourg@pcaobus.org), Thomas Ray, Deputy Chief Auditor (202-207-9112; rayt@pcaobus.org), or Laura Phillips, Associate Chief Auditor (202-207-9111; phillipsl@pcaobus.org).

3. <u>Board's Statement of the Purpose of, and the Statutory Basis for, the Proposed Rules</u>

(a) Purpose

Section 103(a)(1) of the Act authorized the PCAOB to establish, by rule, auditing standards to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by the Act. PCAOB Rule 3100, “Compliance with Auditing and Related Professional Practice Standards,” requires auditors to comply with all applicable auditing and related professional practice standards established by the PCAOB. The Board has adopted as interim standards, on an initial, transitional basis, the generally accepted auditing standards described in the American Institute of Certified Public Accountants' ("AICPA") Auditing Standards Board's Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards,* in existence on April 16, 2003 (the "interim standards").

Section 103(a)(2)(A)(iii) of the Act requires the Board to include in the auditing standards it adopts a standard that describes in each audit report the scope of the auditor’s testing of the internal control structure and procedures of the issuer, required by Section 404(b) of the Act. This standard is the standard referred to in Section 103(a)(2)(A)(iii) and Section 404(b) of the Act.

The statutory basis for the proposed rules is Title I of the Act.

4. <u>Board's Statement on Burden on Competition</u>

The Board does not believe that the proposed rule will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. Pursuant to the Act and PCAOB Rule 3100, registered public accounting firms must comply with all applicable auditing and related professional practice standards established by the PCAOB. Although compliance with the proposed rule will impose costs, those costs are necessary in order to implement the requirements of Sections 103 and 404 of the Act and will be imposed in a way that does not disproportionately or unnecessarily burden competition.

5. Board's Statement on Comments on the Proposed Rules Received from Members, Participants or Others

The Board released the proposed Auditing Standard for public comment on October 7, 2003. See Exhibit 2(a)A. The Board received 193 written comment letters relating to its proposal. See Exhibits 2(a)B and 2(a)C.

The Board has carefully considered all comments it has received. In response to the written comments received, the Board has clarified and modified certain aspects of the proposed rules. The Board's response to the comments it received and the changes made to the rules in response to these comments are summarized in Exhibit 3 to this filing.

6. Extension of Time Period for Commission Action

The Board consents to extend to 60 days the time period for Commission action described in Section 19(b)(2) of the Securities Exchange Act of 1934.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rules Based on Rules of Another Board or of the Commission

The proposed rules are not based on the rules of another board or of the Commission.

9. Exhibits

Exhibit A –	Text of the Proposed Rule
Exhibit 1 –	Form of Notice of Proposed Rule for Publication in the Federal Register.
Exhibit 2(a)A –	PCAOB Release No. 2003-017 (October 7, 2003).
Exhibit 2(a)B –	Alphabetical List of Comments
Exhibit 2(a)C –	Written comments on the rule proposed in PCAOB Release No. 2003-017
Exhibit 3 –	PCAOB Release No. 2004-001 (March 9, 2004)

10. Signatures

Pursuant to the requirements of the Act and the Securities Exchange Act of 1934, as amended, the Board has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

Public Company Accounting Oversight Board

By: ____________________
William J. McDonough
Chairman

EXHIBIT A --Text of the Proposed Rule

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Applicability of Standard

1. This standard establishes requirements and provides directions that apply when an auditor is engaged to audit both a company's financial statements and management's assessment of the effectiveness of internal control over financial reporting.

> Note: The term *auditor* includes both public accounting firms registered with the Public Company Accounting Oversight Board ("PCAOB" or the "Board") and associated persons thereof.

2. A company subject to the reporting requirements of the Securities Exchange Act of 1934 (an "issuer") is required to include in its annual report a report of management on the company's internal control over financial reporting. Registered investment companies, issuers of asset-backed securities, and nonpublic companies are not subject to the reporting requirements mandated by Section 404 of the Sarbanes-Oxley Act of 2002 (the "Act") (PL 107-204). The report of management is required to contain management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including a statement as to whether the company's internal control over financial reporting is effective. The auditor that audits the company's financial statements included in the annual

report is required to attest to and report on management's assessment. The company is required to file the auditor's attestation report as part of the annual report.

> Note: The term issuer means an issuer (as defined in Section 3 of the Securities Exchange Act of 1934), the securities of which are registered under Section 12 of that Act, or that is required to file reports under Section 15(d) of that Act, or that files or has filed a registration statement with the Securities and Exchange Commission ("SEC" or "Commission") that has not yet become effective under the Securities Act of 1933, and that it has not withdrawn.

> Note: Various parts of this standard summarize legal requirements imposed on issuers by the SEC, as well as legal requirements imposed on auditors by regulatory authorities other than the PCAOB. These parts of the standard are intended to provide context and to promote the auditor's understanding of the relationship between his or her obligations under this standard and his or her other legal responsibilities. The standard does not incorporate these legal requirements by reference and is not an interpretation of those other requirements and should not be so construed. (This Note does not apply to references in the standard to the existing professional standards and the Board's interim auditing and related professional practice standards.)

3. This standard is the standard on attestation engagements referred to in Section 404(b) of the Act. This standard is also the standard referred to in Section 103(a)(2)(A)(iii) of the Act. Throughout this standard, the auditor's attestation of management's assessment of the effectiveness of internal control over financial reporting required by Section 404(b) of the Act is referred to as the *audit of internal control over financial reporting*.

> Note: The two terms *audit of internal control over financial reporting* and *attestation of management's assessment of the effectiveness of internal control over financial reporting* refer to the same professional service. The first refers to the process, and the second refers to the result of that process.

Auditor's Objective in an Audit of Internal Control Over Financial Reporting

4. The auditor's objective in an audit of internal control over financial reporting is to express an opinion on management's assessment of the effectiveness of the company's internal control over financial reporting. To form a basis for expressing such an opinion, the auditor must plan and perform the audit to obtain reasonable assurance about whether the company maintained, in all material respects, effective internal control over financial reporting as of the date

specified in management's assessment. The auditor also must audit the company's financial statements as of the date specified in management's assessment because the information the auditor obtains during a financial statement audit is relevant to the auditor's conclusion about the effectiveness of the company's internal control over financial reporting. Maintaining effective internal control over financial reporting means that no material weaknesses exist; therefore, the objective of the audit of internal control over financial reporting is to obtain reasonable assurance that no material weaknesses exist as of the date specified in management's assessment.

5. To obtain reasonable assurance, the auditor evaluates the assessment performed by management and obtains and evaluates evidence about whether the internal control over financial reporting was designed and operated effectively. The auditor obtains this evidence from a number of sources, including using the work performed by others and performing auditing procedures himself or herself.

6. The auditor should be aware that persons who rely on the information concerning internal control over financial reporting include investors, creditors, the board of directors and audit committee, and regulators in specialized industries, such as banking or insurance. The auditor should be aware that external users of financial statements are interested in information on internal control over financial reporting because it enhances the quality of financial reporting and increases their confidence in financial information, including financial information issued between annual reports, such as quarterly information. Information on internal control over financial reporting is also intended to provide an early warning to those inside and outside the company who are in a position to insist on improvements in internal control over financial reporting, such as the audit committee and regulators in specialized industries. Additionally, Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a),[1/] whichever applies, require management, with the participation of the principal executive and financial officers, to make quarterly and annual certifications with respect to the company's internal control over financial reporting.

Definitions Related to Internal Control Over Financial Reporting

7. For purposes of management's assessment and the audit of internal control over financial reporting in this standard, *internal control over financial reporting* is defined as follows:

> A process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing

[1/] See 17 C.F.R. 240.13a-14(a) or 17 C.F.R. 240.15d-14(a), whichever applies.

similar functions, and effected by the company's board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

(1) Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;

(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Note: This definition is the same one used by the SEC in its rules requiring management to report on internal control over financial reporting, except the word "registrant" has been changed to "company" to conform to the wording in this standard. (See Securities Exchange Act Rules 13a-15(f) and 15d-15(f).[2/])

Note: Throughout this standard, *internal control over financial reporting* (singular) refers to the process described in this paragraph. Individual controls or subsets of controls are referred to as *controls* or *controls over financial reporting*.

8. A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

- A deficiency in *design* exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective is not always met.

[2/] See 17 C.F.R. 240, 13a-15(f) and 15d-15(f).

- A deficiency in *operation* exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively.

9. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected.

Note: The term "remote likelihood" as used in the definitions of *significant deficiency* and *material weakness* (paragraph 10) has the same meaning as the term "remote" as used in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies* ("FAS No. 5"). Paragraph 3 of FAS No. 5 states:

> When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms *probable*, *reasonably possible*, and *remote* to identify three areas within that range, as follows:
>
> a. *Probable*. The future event or events are likely to occur.
> b. *Reasonably possible*. The chance of the future event or events occurring is more than remote but less than likely.
> c. *Remote*. The chance of the future events or events occurring is slight.

Therefore, the likelihood of an event is "more than remote" when it is either reasonably possible or probable.

Note: A misstatement is *inconsequential* if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, either individually or when aggregated with other misstatements, would clearly be immaterial to the financial statements. If a reasonable person could not reach such a conclusion regarding a particular misstatement, that misstatement is *more than inconsequential*.

10. A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a

material misstatement of the annual or interim financial statements will not be prevented or detected.

Note: In evaluating whether a control deficiency exists and whether control deficiencies, either individually or in combination with other control deficiencies, are significant deficiencies or material weaknesses, the auditor should consider the definitions in paragraphs 8, 9 and 10, and the directions in paragraphs 130 through 137. As explained in paragraph 23, the evaluation of the materiality of the control deficiency should include both quantitative and qualitative considerations. Qualitative factors that might be important in this evaluation include the nature of the financial statement accounts and assertions involved and the reasonably possible future consequences of the deficiency. Furthermore, in determining whether a control deficiency or combination of deficiencies is a significant deficiency or a material weakness, the auditor should evaluate the effect of compensating controls and whether such compensating controls are effective.

11. Controls over financial reporting may be *preventive controls* or *detective controls*.

- Preventive controls have the objective of preventing errors or fraud from occurring in the first place that could result in a misstatement of the financial statements.

- Detective controls have the objective of detecting errors or fraud that have already occurred that could result in a misstatement of the financial statements.

12. Even well-designed controls that are operating as designed might not prevent a misstatement from occurring. However, this possibility may be countered by overlapping preventive controls or partially countered by detective controls. Therefore, effective internal control over financial reporting often includes a combination of preventive and detective controls to achieve a specific control objective. The auditor's procedures as part of either the audit of internal control over financial reporting or the audit of the financial statements are not part of a company's internal control over financial reporting.

Framework Used by Management to Conduct Its Assessment

13. Management is required to base its assessment of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework established by a body of experts that followed due-process procedures, including the broad distribution of the framework for public comment. In addition to being available to users of management's reports, a framework is suitable only when it:

- Is free from bias;

- Permits reasonably consistent qualitative and quantitative measurements of a company's internal control over financial reporting;

- Is sufficiently complete so that those relevant factors that would alter a conclusion about the effectiveness of a company's internal control over financial reporting are not omitted; and

- Is relevant to an evaluation of internal control over financial reporting.

Committee of Sponsoring Organizations Framework

14. In the United States, the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission has published *Internal Control – Integrated Framework*. Known as the COSO report, it provides a suitable and available framework for purposes of management's assessment. For that reason, the performance and reporting directions in this standard are based on the COSO framework. Other suitable frameworks have been published in other countries and may be developed in the future. Such other suitable frameworks may be used in an audit of internal control over financial reporting. Although different frameworks may not contain exactly the same elements as COSO, they should have elements that encompass, in general, all the themes in COSO. Therefore, the auditor should be able to apply the concepts and guidance in this standard in a reasonable manner.

15. The COSO framework identifies three primary objectives of internal control: efficiency and effectiveness of operations, financial reporting, and compliance with laws and regulations. The COSO perspective on internal control over financial reporting does not ordinarily include the other two objectives of internal control, which are the effectiveness and efficiency of operations and compliance with laws and regulations. However, the controls that management designs and implements may achieve more than one objective. Also, operations and 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. Additionally, not all controls relevant to financial reporting are accounting controls. Accordingly, all controls that could materially affect financial reporting, including controls that focus primarily on the effectiveness and efficiency of operations or compliance with laws and regulations and also have a material effect on the reliability of financial reporting, are a part of internal control over financial reporting. More information about the COSO framework is included in the COSO report and in AU sec. 319,

Consideration of Internal Control in a Financial Statement Audit.[3/] The COSO report also discusses special considerations for internal control over financial reporting for small and medium-sized companies.

Inherent Limitations in Internal Control Over Financial Reporting

16. Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

The Concept of Reasonable Assurance

17. Management's assessment of the effectiveness of internal control over financial reporting is expressed at the level of *reasonable assurance*. The concept of reasonable assurance is built into the definition of internal control over financial reporting and also is integral to the auditor's opinion.[4/] Reasonable assurance includes the understanding that there is a remote likelihood that material misstatements will not be prevented or detected on a timely basis. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance.

18. Just as there are inherent limitations on the assurance that effective internal control over financial reporting can provide, as discussed in paragraph 16, there are limitations on the amount of assurance the auditor can obtain as a result of performing his or her audit of internal control over financial reporting. Limitations arise because an audit is conducted on a test basis and requires the

[3/] The Board adopted the generally accepted auditing standards, as described in the AICPA Auditing Standards Board's ("ASB") Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards,* as in existence on April 16, 2003, on an initial, transitional basis. The Statements on Auditing Standards promulgated by the ASB have been codified into the AICPA *Professional Standards,* Volume 1, as AU sections 100 through 900. References in this standard to AU sections refer to those generally accepted auditing standards, as adopted on an interim basis in PCAOB Rule 3200T.

[4/] See *Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports,* Securities and Exchange Commission Release No. 33-8238 (June 5, 2003) [68 FR 36636] for further discussion of reasonable assurance.

exercise of professional judgment. Nevertheless, the audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control over financial reporting, and performing such other procedures as the auditor considers necessary to obtain reasonable assurance about whether internal control over financial reporting is effective.

19. There is no difference in the level of work performed or assurance obtained by the auditor when expressing an opinion on management's assessment of effectiveness or when expressing an opinion directly on the effectiveness of internal control over financial reporting. In either case, the auditor must obtain sufficient evidence to provide a reasonable basis for his or her opinion and the use and evaluation of management's assessment is inherent in expressing either opinion.

> Note: The auditor's report on internal control over financial reporting does not relieve management of its responsibility for assuring users of its financial reports about the effectiveness of internal control over financial reporting.

Management's Responsibilities in an Audit of Internal Control Over Financial Reporting

20. For the auditor to satisfactorily complete an audit of internal control over financial reporting, management must do the following:[5/]

a. Accept responsibility for the effectiveness of the company's internal control over financial reporting;

b. Evaluate the effectiveness of the company's internal control over financial reporting using suitable control criteria;

c. Support its evaluation with sufficient evidence, including documentation; and

d. Present a written assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year.

21. If the auditor concludes that management has not fulfilled the responsibilities enumerated in the preceding paragraph, the auditor should communicate, in writing, to management and the audit committee that the audit

[5/] Management is required to fulfill these responsibilities. See Items 308(a) and (c) of Regulation S-B and S-K, 17 C.F.R. 228.308 (a) and (c) and 229.308 (a) and (c), respectively.

of internal control over financial reporting cannot be satisfactorily completed and that he or she is required to disclaim an opinion. Paragraphs 40 through 46 provide information for the auditor about evaluating management's process for assessing internal control over financial reporting.

Materiality Considerations in an Audit of Internal Control Over Financial Reporting

22. The auditor should apply the concept of materiality in an audit of internal control over financial reporting at both the financial-statement level and at the individual account-balance level. The auditor uses materiality at the financial-statement level in evaluating whether a deficiency, or combination of deficiencies, in controls is a significant deficiency or a material weakness. Materiality at both the financial-statement level and the individual account-balance level is relevant to planning the audit and designing procedures. Materiality at the account-balance level is necessarily lower than materiality at the financial-statement level.

23. The same conceptual definition of materiality that applies to financial reporting applies to information on internal control over financial reporting, including the relevance of both quantitative and qualitative considerations.[6/]

- The quantitative considerations are essentially the same as in an audit of financial statements and relate to whether misstatements that would not be prevented or detected by internal control over financial reporting, individually or collectively, have a quantitatively material effect on the financial statements.

- The qualitative considerations apply to evaluating materiality with respect to the financial statements and to additional factors that relate to the perceived needs of reasonable persons who will rely on the information. Paragraph 6 describes some qualitative considerations.

Fraud Considerations in an Audit of Internal Control Over Financial Reporting

24. The auditor should evaluate all controls specifically intended to address the risks of fraud that have at least a reasonably possible likelihood of having a material effect on the company's financial statements. These controls may be a part of any of the five components of internal control over financial reporting, as discussed in paragraph 49. Controls related to the prevention and detection of

[6/] AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, provides additional explanation of materiality.

fraud often have a pervasive effect on the risk of fraud. Such controls include, but are not limited to, the:

- Controls restraining misappropriation of company assets that could result in a material misstatement of the financial statements;

- Company's risk assessment processes;

- Code of ethics/conduct provisions, especially those related to conflicts of interest, related party transactions, illegal acts, and the monitoring of the code by management and the audit committee or board;

- Adequacy of the internal audit activity and whether the internal audit function reports directly to the audit committee, as well as the extent of the audit committee's involvement and interaction with internal audit; and

- Adequacy of the company's procedures for handling complaints and for accepting confidential submissions of concerns about questionable accounting or auditing matters.

25. Part of management's responsibility when designing a company's internal control over financial reporting is to design and implement programs and controls to prevent, deter, and detect fraud. Management, along with those who have responsibility for oversight of the financial reporting process (such as the audit committee), should set the proper tone; create and maintain a culture of honesty and high ethical standards; and establish appropriate controls to prevent, deter, and detect fraud. When management and those responsible for the oversight of the financial reporting process fulfill those responsibilities, the opportunities to commit fraud can be reduced significantly.

26. In an audit of internal control over financial reporting, the auditor's evaluation of controls is interrelated with the auditor's evaluation of controls in a financial statement audit, as required by AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*. Often, controls identified and evaluated by the auditor during the audit of internal control over financial reporting also address or mitigate fraud risks, which the auditor is required to consider in a financial statement audit. If the auditor identifies deficiencies in controls designed to prevent and detect fraud during the audit of internal control over financial reporting, the auditor should alter the nature, timing, or extent of procedures to be performed during the financial statement audit to be responsive to such deficiencies, as provided in paragraphs .44 and .45 of AU sec. 316.

Performing an Audit of Internal Control Over Financial Reporting

27. In an audit of internal control over financial reporting, the auditor must obtain sufficient competent evidence about the design and operating effectiveness of controls over all relevant financial statement assertions related to all significant accounts and disclosures in the financial statements. The auditor must plan and perform the audit to obtain reasonable assurance that deficiencies that, individually or in the aggregate, would represent material weaknesses are identified. Thus, the audit is not designed to detect deficiencies in internal control over financial reporting that, individually or in the aggregate, are less severe than a material weakness. Because of the potential significance of the information obtained during the audit of the financial statements to the auditor's conclusions about the effectiveness of internal control over financial reporting, the auditor cannot audit internal control over financial reporting without also auditing the financial statements.

> Note: However, the auditor may audit the financial statements without also auditing internal control over financial reporting, for example, in the case of certain initial public offerings by a company. See the discussion beginning at paragraph 145 for more information about the importance of auditing both internal control over financial reporting as well as the financial statements when the auditor is engaged to audit internal control over financial reporting.

28. The auditor must adhere to the general standards (See paragraphs 30 through 36) and fieldwork and reporting standards (See paragraph 37) in performing an audit of a company's internal control over financial reporting. This involves the following:

a. Planning the engagement;

b. Evaluating management's assessment process;

c. Obtaining an understanding of internal control over financial reporting;

d. Testing and evaluating design effectiveness of internal control over financial reporting;

e. Testing and evaluating operating effectiveness of internal control over financial reporting; and

f. Forming an opinion on the effectiveness of internal control over financial reporting.

29. Even though some requirements of this standard are set forth in a manner that suggests a sequential process, auditing internal control over financial reporting involves a process of gathering, updating, and analyzing information.

Accordingly, the auditor may perform some of the procedures and evaluations described in this section on "Performing an Audit of Internal Control Over Financial Reporting" concurrently.

Applying General, Fieldwork, and Reporting Standards

30. The general standards (See AU sec. 150, *Generally Accepted Auditing Standards*) are applicable to an audit of internal control over financial reporting. These standards require technical training and proficiency as an auditor, independence in fact and appearance, and the exercise of due professional care, including professional skepticism.

31. *Technical Training and Proficiency*. To perform an audit of internal control over financial reporting, the auditor should have competence in the subject matter of internal control over financial reporting.

32. *Independence*. The applicable requirements of independence are largely predicated on four basic principles: (1) an auditor must not act as management or as an employee of the audit client, (2) an auditor must not audit his or her own work, (3) an auditor must not serve in a position of being an advocate for his or her client, and (4) an auditor must not have mutual or conflicting interests with his or her audit client.[7/] If the auditor were to design or implement controls, that situation would place the auditor in a management role and result in the auditor auditing his or her own work. These requirements, however, do not preclude the auditor from making substantive recommendations as to how management may improve the design or operation of the company's internal controls as a by-product of an audit.

33. The auditor must not accept an engagement to provide internal control-related services to an issuer for which the auditor also audits the financial statements unless that engagement has been specifically pre-approved by the audit committee. For any internal control services the auditor provides, management must be actively involved and cannot delegate responsibility for these matters to the auditor. Management's involvement must be substantive and extensive. Management's acceptance of responsibility for documentation and testing performed by the auditor does not by itself satisfy the independence requirements.

34. Maintaining independence, in fact and appearance, requires careful attention, as is the case with all independence issues when work concerning internal control over financial reporting is performed. Unless the auditor and the audit committee are diligent in evaluating the nature and extent of services

[7/] See the Preliminary Note of Rule 2-01 of Regulation S-X, 17 C.F.R. 210.2-01.

provided, the services might violate basic principles of independence and cause an impairment of independence in fact or appearance.

35. The independent auditor and the audit committee have significant and distinct responsibilities for evaluating whether the auditor's services impair independence in fact or appearance. The test for independence in fact is whether the activities would impede the ability of anyone on the engagement team or in a position to influence the engagement team from exercising objective judgment in the audits of the financial statements or internal control over financial reporting. The test for independence in appearance is whether a reasonable investor, knowing all relevant facts and circumstances, would perceive an auditor as having interests which could jeopardize the exercise of objective and impartial judgments on all issues encompassed within the auditor's engagement.

36. *Due Professional Care*. The auditor must exercise due professional care in an audit of internal control over financial reporting. One important tenet of due professional care is exercising professional skepticism. In an audit of internal control over financial reporting, exercising professional skepticism involves essentially the same considerations as in an audit of financial statements, that is, it includes a critical assessment of the work that management has performed in evaluating and testing controls.

37. *Fieldwork and Reporting Standards*. This standard establishes the fieldwork and reporting standards applicable to an audit of internal control over financial reporting.

38. The concept of materiality, as discussed in paragraphs 22 and 23, underlies the application of the general and fieldwork standards.

Planning the Engagement

39. The audit of internal control over financial reporting should be properly planned and assistants, if any, are to be properly supervised. When planning the audit of internal control over financial reporting, the auditor should evaluate how the following matters will affect the auditor's procedures:

- Knowledge of the company's internal control over financial reporting obtained during other engagements.
- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes.
- Matters relating to the company's business, including its organization, operating characteristics, capital structure, and distribution methods.

- The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting.

- Management's process for assessing the effectiveness of the company's internal control over financial reporting based upon control criteria.

- Preliminary judgments about materiality, risk, and other factors relating to the determination of material weaknesses.

- Control deficiencies previously communicated to the audit committee or management.

- Legal or regulatory matters of which the company is aware.

- The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting.

- Preliminary judgments about the effectiveness of internal control over financial reporting.

- The number of significant business locations or units, including management's documentation and monitoring of controls over such locations or business units. (Appendix B, paragraphs B1 through B17, discusses factors the auditor should evaluate to determine the locations at which to perform auditing procedures.)

Evaluating Management's Assessment Process

40. The auditor must obtain an understanding of, and evaluate, management's process for assessing the effectiveness of the company's internal control over financial reporting. When obtaining the understanding, the auditor should determine whether management has addressed the following elements:

- Determining which controls should be tested, including controls over all relevant assertions related to all significant accounts and disclosures in the financial statements. Generally, such controls include:

  – Controls over initiating, authorizing, recording, processing, and reporting significant accounts and disclosures and related assertions embodied in the financial statements.

- Controls over the selection and application of accounting policies that are in conformity with generally accepted accounting principles.
- Antifraud programs and controls.
- Controls, including information technology general controls, on which other controls are dependent.
- Controls over significant nonroutine and nonsystematic transactions, such as accounts involving judgments and estimates.
- Company level controls (as described in paragraph 53), including:
  - The control environment and
  - Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; to initiate, authorize, record, and process journal entries in the general ledger; and to record recurring and nonrecurring adjustments to the financial statements (for example, consolidating adjustments, report combinations, and reclassifications).

    Note: References to the period-end financial reporting process in this standard refer to the preparation of both annual and quarterly financial statements.

• Evaluating the likelihood that failure of the control could result in a misstatement, the magnitude of such a misstatement, and the degree to which other controls, if effective, achieve the same control objectives.

• Determining the locations or business units to include in the evaluation for a company with multiple locations or business units (See paragraphs B1 through B17).

• Evaluating the design effectiveness of controls.

• Evaluating the operating effectiveness of controls based on procedures sufficient to assess their operating effectiveness. Examples of such procedures include testing of the controls by internal audit, testing of controls by others under the direction of management, using a service organization's reports (See paragraphs B18 through B29), inspection of evidence of the application of controls, or testing by means of a self-assessment process, some of which might occur as part of management's ongoing monitoring activities. Inquiry alone is not adequate to complete this evaluation. To evaluate the effectiveness of the company's internal control over financial reporting, management must have evaluated controls over all relevant assertions related to all significant accounts and disclosures.

- Determining the deficiencies in internal control over financial reporting that are of such a magnitude and likelihood of occurrence that they constitute significant deficiencies or material weaknesses.

- Communicating findings to the auditor and to others, if applicable.

- Evaluating whether findings are reasonable and support management's assessment.

41. As part of the understanding and evaluation of management's process, the auditor should obtain an understanding of the results of procedures performed by others. Others include internal audit and third parties working under the direction of management, including other auditors and accounting professionals engaged to perform procedures as a basis for management's assessment. Inquiry of management and others is the beginning point for obtaining an understanding of internal control over financial reporting, but inquiry alone is not adequate for reaching a conclusion on any aspect of internal control over financial reporting effectiveness.

Note: Management cannot use the auditor's procedures as part of the basis for its assessment of the effectiveness of internal control over financial reporting.

42. *Management's Documentation*. When determining whether management's documentation provides reasonable support for its assessment, the auditor should evaluate whether such documentation includes the following:

- The design of controls over all relevant assertions related to all significant accounts and disclosures in the financial statements. The documentation should include the five components of internal control over financial reporting as discussed in paragraph 49, including the control environment and company-level controls as described in paragraph 53;

- Information about how significant transactions are initiated, authorized, recorded, processed and reported;

- Sufficient information about the flow of transactions to identify the points at which material misstatements due to error or fraud could occur;

- Controls designed to prevent or detect fraud, including who performs the controls and the related segregation of duties;

- Controls over the period-end financial reporting process;

- Controls over safeguarding of assets (See paragraphs C1 through C6); and

- The results of management's testing and evaluation.

43. Documentation might take many forms, such as paper, electronic files, or other media, and can include a variety of information, including policy manuals, process models, flowcharts, job descriptions, documents, and forms. The form and extent of documentation will vary depending on the size, nature, and complexity of the company.

44. Documentation of the design of controls over relevant assertions related to significant accounts and disclosures is evidence that controls related to management's assessment of the effectiveness of internal control over financial reporting, including changes to those controls, have been identified, are capable of being communicated to those responsible for their performance, and are capable of being monitored by the company. Such documentation also provides the foundation for appropriate communication concerning responsibilities for performing controls and for the company's evaluation of and monitoring of the effective operation of controls.

45. Inadequate documentation of the design of controls over relevant assertions related to significant accounts and disclosures is a deficiency in the company's internal control over financial reporting. As discussed in paragraph 138, the auditor should evaluate this documentation deficiency. The auditor might conclude that the deficiency is only a deficiency, or that the deficiency represents a significant deficiency or a material weakness. In evaluating the deficiency as to its significance, the auditor should determine whether management can demonstrate the monitoring component of internal control over financial reporting.

46. Inadequate documentation also could cause the auditor to conclude that there is a limitation on the scope of the engagement.

Obtaining an Understanding of Internal Control Over Financial Reporting

47. The auditor should obtain an understanding of the design of specific controls by applying procedures that include:

- Making inquiries of appropriate management, supervisory, and staff personnel;
- Inspecting company documents;
- Observing the application of specific controls; and
- Tracing transactions through the information system relevant to financial reporting.

48. The auditor could also apply additional procedures to obtain an understanding of the design of specific controls.

49. The auditor must obtain an understanding of the design of controls related to each component of internal control over financial reporting, as discussed below.

- *Control Environment*. Because of the pervasive effect of the control environment on the reliability of financial reporting, the auditor's preliminary judgment about its effectiveness often influences the nature, timing, and extent of the tests of operating effectiveness considered necessary. Weaknesses in the control environment should cause the auditor to alter the nature, timing, or extent of tests of operating effectiveness that otherwise should have been performed in the absence of the weaknesses.
- *Risk Assessment*. When obtaining an understanding of the company's risk assessment process, the auditor should evaluate whether management has identified the risks of material misstatement in the significant accounts and disclosures and related assertions of the financial statements and has implemented controls to prevent or detect errors or fraud that could result in material misstatements. For example, the risk assessment process should address how management considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements. Risks relevant to reliable financial reporting also relate to specific events or transactions.
- *Control Activities*. The auditor's understanding of control activities relates to the controls that management has implemented to

prevent or detect errors or fraud that could result in material misstatement in the accounts and disclosures and related assertions of the financial statements. For the purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained for the financial statement audit.

- *Information and Communication*. The auditor's understanding of management's information and communication involves understanding the same systems and processes that he or she addresses in an audit of financial statements. In addition, this understanding includes a greater emphasis on comprehending the safeguarding controls and the processes for authorization of transactions and the maintenance of records, as well as the period-end financial reporting process (discussed further beginning at paragraph 76).

- *Monitoring*. The auditor's understanding of management's monitoring of controls extends to and includes its monitoring of all controls, including control activities, which management has identified and designed to prevent or detect material misstatement in the accounts and disclosures and related assertions of the financial statements.

50. Some controls (such as company-level controls, described in paragraph 53) might have a pervasive effect on the achievement of many overall objectives of the control criteria. For example, information technology general controls over program development, program changes, computer operations, and access to programs and data help ensure that specific controls over the processing of transactions are operating effectively. In contrast, other controls are designed to achieve specific objectives of the control criteria. For example, management generally establishes specific controls, such as accounting for all shipping documents, to ensure that all valid sales are recorded.

51. The auditor should focus on combinations of controls, in addition to specific controls in isolation, in assessing whether the objectives of the control criteria have been achieved. The absence or inadequacy of a specific control designed to achieve the objectives of a specific criterion might not be a deficiency if other controls specifically address the same criterion. Further, when one or more controls achieve the objectives of a specific criterion, the auditor might not need to evaluate other controls designed to achieve those same objectives.

52. *Identifying Company-Level Controls*. Controls that exist at the company-level often have a pervasive impact on controls at the process, transaction, or

application level. For that reason, as a practical consideration, it may be appropriate for the auditor to test and evaluate the design effectiveness of company-level controls first, because the results of that work might affect the way the auditor evaluates the other aspects of internal control over financial reporting.

53. Company-level controls are controls such as the following:

- Controls within the control environment, including tone at the top, the assignment of authority and responsibility, consistent policies and procedures, and company-wide programs, such as codes of conduct and fraud prevention, that apply to all locations and business units (See paragraphs 113 through 115 for further discussion);

- Management's risk assessment process;

- Centralized processing and controls, including shared service environments;

- Controls to monitor results of operations;

- Controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs;

- The period-end financial reporting process; and

- Board-approved policies that address significant business control and risk management practices.

Note: The controls listed above are not intended to be a complete list of company-level controls nor is a company required to have all the controls in the list to support its assessment of effective company-level controls. However, ineffective company-level controls are a deficiency that will affect the scope of work performed, particularly when a company has multiple locations or business units, as described in Appendix B.

54. Testing company-level controls alone is not sufficient for the purpose of expressing an opinion on the effectiveness of a company's internal control over financial reporting.

55. *Evaluating the Effectiveness of the Audit Committee's Oversight of the Company's External Financial Reporting and Internal Control Over Financial Reporting*. The company's audit committee plays an important role within the control environment and monitoring components of internal control over financial reporting. Within the control environment, the existence of an effective audit committee helps to set a positive tone at the top. Within the monitoring

component, an effective audit committee challenges the company's activities in the financial arena.

> Note: Although the audit committee plays an important role within the control environment and monitoring components of internal control over financial reporting, management is responsible for maintaining effective internal control over financial reporting. This standard does not suggest that this responsibility has been transferred to the audit committee.

> Note: If no such committee exists with respect to the company, all references to the audit committee in this standard apply to the entire board of directors of the company.[8/] The auditor should be aware that companies whose securities are not listed on a national securities exchange or an automated inter-dealer quotation system of a national securities association (such as the New York Stock Exchange, American Stock Exchange, or NASDAQ) may not be required to have independent directors for their audit committees. In this case, the auditor should not consider the lack of independent directors at these companies indicative, by itself, of a control deficiency. Likewise, the independence requirements of Securities Exchange Act Rule 10A-3[9/] are not applicable to the listing of non-equity securities of a consolidated or at least 50 percent beneficially owned subsidiary of a listed issuer that is subject to the requirements of Securities Exchange Act Rule 10A-3(c)(2).[10/] Therefore, the auditor should interpret references to the audit committee in this standard, as applied to a subsidiary registrant, as being consistent with the provisions of Securities Exchange Act Rule 10A-3(c)(2).[11/] Furthermore, for subsidiary registrants, communications required by this standard to be directed to the audit committee should be made to the same committee or equivalent body that pre-approves the retention of the auditor by or on behalf of the subsidiary registrant pursuant to Rule 2-01(c)(7) of Regulation S-X[12/] (which might be, for example, the audit committee of the subsidiary registrant, the full board of the subsidiary registrant, or the audit committee of the subsidiary registrant's parent). In all cases, the auditor should interpret the terms "board of directors" and "audit committee" in this standard as being consistent with provisions for the use of those terms as defined in relevant SEC rules.

8/ See 15 U.S.C. 78c(a)58 and 15 U.S.C. 7201(a)(3).

9/ See 17 C.F.R. 240.10A-3.

10/ See 17 C.F.R. 240.10A-3(c)(2).

11/ See 17 C.F.R. 240.10A-3(c)(2).

12/ See 17 C.F.R. 210.2-01(c)(7).

56. The company's board of directors is responsible for evaluating the performance and effectiveness of the audit committee; this standard does not suggest that the auditor is responsible for performing a separate and distinct evaluation of the audit committee. However, because of the role of the audit committee within the control environment and monitoring components of internal control over financial reporting, the auditor should assess the effectiveness of the audit committee as part of understanding and evaluating those components.

57. The aspects of the audit committee's effectiveness that are important may vary considerably with the circumstances. The auditor focuses on factors related to the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting, such as the independence of the audit committee members from management and the clarity with which the audit committee's responsibilities are articulated (for example, in the audit committee's charter) and how well the audit committee and management understand those responsibilities. The auditor might also consider the audit committee's involvement and interaction with the independent auditor and with internal auditors, as well as interaction with key members of financial management, including the chief financial officer and chief accounting officer.

58. The auditor might also evaluate whether the right questions are raised and pursued with management and the auditor, including questions that indicate an understanding of the critical accounting policies and judgmental accounting estimates, and the responsiveness to issues raised by the auditor.

59. Ineffective oversight by the audit committee of the company's external financial reporting and internal control over financial reporting should be regarded as at least a significant deficiency and is a strong indicator that a material weakness in internal control over financial reporting exists.

60. *Identifying Significant Accounts*. The auditor should identify significant accounts and disclosures, first at the financial-statement level and then at the account or disclosure-component level. Determining specific controls to test begins by identifying significant accounts and disclosures within the financial statements. When identifying significant accounts, the auditor should evaluate both quantitative and qualitative factors.

61. An account is significant if there is more than a remote likelihood that the account could contain misstatements that individually, or when aggregated with others, could have a material effect on the financial statements, considering the risks of both overstatement and understatement. Other accounts may be significant on a qualitative basis based on the expectations of a reasonable user. For example, investors might be interested in a particular financial statement account even though it is not quantitatively large because it represents an important performance measure.

Note: For purposes of determining significant accounts, the assessment as to likelihood should be made without giving any consideration to the effectiveness of internal control over financial reporting.

62. Components of an account balance subject to differing risks (inherent and control) or different controls should be considered separately as potential significant accounts. For instance, inventory accounts often consist of raw materials (purchasing process), work in process (manufacturing process), finished goods (distribution process), and an allowance for obsolescence.

63. In some cases, separate components of an account might be a significant account because of the company's organizational structure. For example, for a company that has a number of separate business units, each with different management and accounting processes, the accounts at each separate business unit are considered individually as potential significant accounts.

64. An account also may be considered significant because of the exposure to unrecognized obligations represented by the account. For example, loss reserves related to a self-insurance program or unrecorded contractual obligations at a construction contracting subsidiary may have historically been insignificant in amount, yet might represent a more than remote likelihood of material misstatement due to the existence of material unrecorded claims.

65. When deciding whether an account is significant, it is important for the auditor to evaluate both quantitative and qualitative factors, including the:

- Size and composition of the account;
- Susceptibility of loss due to errors or fraud;
- Volume of activity, complexity, and homogeneity of the individual transactions processed through the account;
- Nature of the account (for example, suspense accounts generally warrant greater attention);
- Accounting and reporting complexities associated with the account;
- Exposure to losses represented by the account (for example, loss accruals related to a consolidated construction contracting subsidiary);
- Likelihood (or possibility) of significant contingent liabilities arising from the activities represented by the account;

- Existence of related party transactions in the account; and
- Changes from the prior period in account characteristics (for example, new complexities or subjectivity or new types of transactions).

66. For example, in a financial statement audit, the auditor might not consider the fixed asset accounts significant when there is a low volume of transactions and when inherent risk is assessed as low, even though the balances are material to the financial statements. Accordingly, he or she might decide to perform only substantive procedures on such balances. In an audit of internal control over financial reporting, however, such accounts are significant accounts because of their materiality to the financial statements.

67. As another example, the auditor of the financial statements of a financial institution might not consider trust accounts significant to the institution's financial statements because such accounts are not included in the institution's balance sheet and the associated fee income generated by trust activities is not material. However, in determining whether trust accounts are a significant account for purposes of the audit of internal control over financial reporting, the auditor should assess whether the activities of the trust department are significant to the institution's financial reporting, which also would include considering the contingent liabilities that could arise if a trust department failed to fulfill its fiduciary responsibilities (for example, if investments were made that were not in accordance with stated investment policies). When assessing the significance of possible contingent liabilities, consideration of the amount of assets under the trust department's control may be useful. For this reason, an auditor who has not considered trust accounts significant accounts for purposes of the financial statement audit might determine that they are significant for purposes of the audit of internal control over financial reporting.

68. Identifying Relevant Financial Statement Assertions. For each significant account, the auditor should determine the relevance of each of these financial statement assertions:[13/]

- Existence or occurrence;
- Completeness;
- Valuation or allocation;
- Rights and obligations; and

[13/] See AU sec. 326, *Evidential Matter*, which provides additional information on financial statement assertions.

- Presentation and disclosure.

69. To identify relevant assertions, the auditor should determine the source of likely potential misstatements in each significant account. In determining whether a particular assertion is relevant to a significant account balance or disclosure, the auditor should evaluate:

- The nature of the assertion;

- The volume of transactions or data related to the assertion; and

- The nature and complexity of the systems, including the use of information technology by which the company processes and controls information supporting the assertion.

70. *Relevant assertions* are assertions that have a meaningful bearing on whether the account is fairly stated. For example, valuation may not be relevant to the cash account unless currency translation is involved; however, existence and completeness are always relevant. Similarly, valuation may not be relevant to the gross amount of the accounts receivable balance, but is relevant to the related allowance accounts. Additionally, the auditor might, in some circumstances, focus on the presentation and disclosure assertion separately in connection with the period-end financial reporting process.

71. *Identifying Significant Processes and Major Classes of Transactions*. The auditor should identify each significant process over each major class of transactions affecting significant accounts or groups of accounts. Major classes of transactions are those classes of transactions that are significant to the company's financial statements. For example, at a company whose sales may be initiated by customers through personal contact in a retail store or electronically through use of the internet, these types of sales would be two major classes of transactions within the sales process if they were both significant to the company's financial statements. As another example, at a company for which fixed assets is a significant account, recording depreciation expense would be a major class of transactions.

72. Different types of major classes of transactions have different levels of inherent risk associated with them and require different levels of management supervision and involvement. For this reason, the auditor might further categorize the identified major classes of transactions by transaction type: routine, nonroutine, and estimation.

- Routine transactions are recurring financial activities reflected in the accounting records in the normal course of business (for example, sales, purchases, cash receipts, cash disbursements, payroll).

- Nonroutine transactions are activities that occur only periodically (for example, taking physical inventory, calculating depreciation expense, adjusting for foreign currencies). A distinguishing feature of nonroutine transactions is that data involved are generally not part of the routine flow of transactions.

- Estimation transactions are activities that involve management judgments or assumptions in formulating account balances in the absence of a precise means of measurement (for example, determining the allowance for doubtful accounts, establishing warranty reserves, assessing assets for impairment).

73. Most processes involve a series of tasks such as capturing input data, sorting and merging data, making calculations, updating transactions and master files, generating transactions, and summarizing and displaying or reporting data. The processing procedures relevant for the auditor to understand the flow of transactions generally are those activities required to initiate, authorize, record, process and report transactions. Such activities include, for example, initially recording sales orders, preparing shipping documents and invoices, and updating the accounts receivable master file. The relevant processing procedures also include procedures for correcting and reprocessing previously rejected transactions and for correcting erroneous transactions through adjusting journal entries.

74. For each significant process, the auditor should:

- Understand the flow of transactions, including how transactions are initiated, authorized, recorded, processed, and reported.

- Identify the points within the process at which a misstatement – including a misstatement due to fraud – related to each relevant financial statement assertion could arise.

- Identify the controls that management has implemented to address these potential misstatements.

- Identify the controls that management has implemented over the prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets.

Note: The auditor frequently obtains the understanding and identifies the controls described above as part of his or her performance of walkthroughs (as described beginning in paragraph 79).

75. The nature and characteristics of a company's use of information technology in its information system affect the company's internal control over financial reporting. AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, paragraphs .16 through .20, .30 through .32, and .77 through .79, discuss the effect of information technology on internal control over financial reporting.

76. *Understanding the Period-end Financial Reporting Process*. The period-end financial reporting process includes the following:

- The procedures used to enter transaction totals into the general ledger;
- The procedures used to initiate, authorize, record, and process journal entries in the general ledger;
- Other procedures used to record recurring and nonrecurring adjustments to the annual and quarterly financial statements, such as consolidating adjustments, report combinations, and classifications; and
- Procedures for drafting annual and quarterly financial statements and related disclosures.

77. As part of understanding and evaluating the period-end financial reporting process, the auditor should evaluate:

- The inputs, procedures performed, and outputs of the processes the company uses to produce its annual and quarterly financial statements;
- The extent of information technology involvement in each period-end financial reporting process element;
- Who participates from management;
- The number of locations involved;
- Types of adjusting entries (for example, standard, nonstandard, eliminating, and consolidating); and
- The nature and extent of the oversight of the process by appropriate parties, including management, the board of directors, and the audit committee.

78. The period-end financial reporting process is always a significant process because of its importance to financial reporting and to the auditor's opinions on internal control over financial reporting and the financial statements. The auditor's understanding of the company's period-end financial reporting process and how it interrelates with the company's other significant processes assists the auditor in identifying and testing controls that are the most relevant to financial statement risks.

79. *Performing Walkthroughs*. The auditor should perform at least one walkthrough for each major class of transactions (as identified in paragraph 71). In a walkthrough, the auditor traces a transaction from origination through the company's information systems until it is reflected in the company's financial reports. Walkthroughs provide the auditor with evidence to:

- Confirm the auditor's understanding of the process flow of transactions;

- Confirm the auditor's understanding of the design of controls identified for all five components of internal control over financial reporting, including those related to the prevention or detection of fraud;

- Confirm that the auditor's understanding of the process is complete by determining whether all points in the process at which misstatements related to each relevant financial statement assertion that could occur have been identified;

- Evaluate the effectiveness of the design of controls; and

- Confirm whether controls have been placed in operation.

Note: The auditor can often gain an understanding of the transaction flow, identify and understand controls, and conduct the walkthrough simultaneously.

80. The auditor's walkthroughs should encompass the entire process of initiating, authorizing, recording, processing, and reporting individual transactions and controls for each of the significant processes identified, including controls intended to address the risk of fraud. During the walkthrough, at each point at which important processing procedures or controls occur, the auditor should question the company's personnel about their understanding of what is required by the company's prescribed procedures and controls and determine whether the processing procedures are performed as originally understood and on a timely basis. (Controls might not be performed regularly but still be timely.) During the walkthrough, the auditor should be alert for exceptions to the company's prescribed procedures and controls.

81. While performing a walkthrough, the auditor should evaluate the quality of the evidence obtained and perform walkthrough procedures that produce a level of evidence consistent with the objectives listed in paragraph 79. Rather than reviewing copies of documents and making inquiries of a single person at the company, the auditor should follow the process flow of actual transactions using the same documents and information technology that company personnel use and make inquiries of relevant personnel involved in significant aspects of the process or controls. To corroborate information at various points in the walkthrough, the auditor might ask personnel to describe their understanding of the previous and succeeding processing or control activities and to demonstrate what they do. In addition, inquiries should include follow-up questions that could help identify the abuse of controls or indicators of fraud. Examples of follow-up inquiries include asking personnel:

- What they do when they find an error or what they are looking for to determine if there is an error (rather than simply asking them if they perform listed procedures and controls); what kind of errors they have found; what happened as a result of finding the errors, and how the errors were resolved. If the person being interviewed has never found an error, the auditor should evaluate whether that situation is due to good preventive controls or whether the individual performing the control lacks the necessary skills.

- Whether they have ever been asked to override the process or controls, and if so, to describe the situation, why it occurred, and what happened.

82. During the period under audit, when there have been significant changes in the process flow of transactions, including the supporting computer applications, the auditor should evaluate the nature of the change(s) and the effect on related accounts to determine whether to walk through transactions that were processed both before and after the change.

> Note: Unless significant changes in the process flow of transactions, including the supporting computer applications, make it more efficient for the auditor to prepare new documentation of a walkthrough, the auditor may carry his or her documentation forward each year, after updating it for any changes that have taken place.

83. *Identifying Controls to Test*. The auditor should obtain evidence about the effectiveness of controls (either by performing tests of controls himself or herself, or by using the work of others)[14/] for all relevant assertions related to all

[14/] See paragraphs 108 through 126 for additional direction on using the work of others.

significant accounts and disclosures in the financial statements. After identifying significant accounts, relevant assertions, and significant processes, the auditor should evaluate the following to identify the controls to be tested:

- Points at which errors or fraud could occur;

- The nature of the controls implemented by management;

- The significance of each control in achieving the objectives of the control criteria and whether more than one control achieves a particular objective or whether more than one control is necessary to achieve a particular objective; and

- The risk that the controls might not be operating effectively. Factors that affect whether the control might not be operating effectively include the following:

  – Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness;

  – Whether there have been changes in the design of controls;

  – The degree to which the control relies on the effectiveness of other controls (for example, the control environment or information technology general controls);

  – Whether there have been changes in key personnel who perform the control or monitor its performance;

  – Whether the control relies on performance by an individual or is automated; and

  – The complexity of the control.

84. The auditor should clearly link individual controls with the significant accounts and assertions to which they relate.

85. The auditor should evaluate whether to test preventive controls, detective controls, or a combination of both for individual relevant assertions related to individual significant accounts. For instance, when performing tests of preventive and detective controls, the auditor might conclude that a deficient preventive control could be compensated for by an effective detective control and, therefore, not result in a significant deficiency or material weakness. For example, a monthly reconciliation control procedure, which is a detective control, might detect an out-of-balance situation resulting from an unauthorized transaction

being initiated due to an ineffective authorization procedure, which is a preventive control. When determining whether the detective control is effective, the auditor should evaluate whether the detective control is sufficient to achieve the control objective to which the preventive control relates.

> Note: Because effective internal control over financial reporting often includes a combination of preventive and detective controls, the auditor ordinarily will test a combination of both.

86. The auditor should apply tests of controls to those controls that are important to achieving each control objective. It is neither necessary to test all controls nor is it necessary to test redundant controls (that is, controls that duplicate other controls that achieve the same objective and already have been tested), unless redundancy is itself a control objective, as in the case of certain computer controls.

87. Appendix B, paragraphs B1 through B17, provide additional direction to the auditor in determining which controls to test when a company has multiple locations or business units. In these circumstances, the auditor should determine significant accounts and their relevant assertions, significant processes, and major classes of transactions based on those that are relevant and significant to the consolidated financial statements. Having made those determinations in relation to the consolidated financial statements, the auditor should then apply the directions in Appendix B.

Testing and Evaluating Design Effectiveness

88. Internal control over financial reporting is effectively designed when the controls complied with would be expected to prevent or detect errors or fraud that could result in material misstatements in the financial statements. The auditor should determine whether the company has controls to meet the objectives of the control criteria by:

- Identifying the company's control objectives in each area;
- Identifying the controls that satisfy each objective; and
- Determining whether the controls, if operating properly, can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.

89. Procedures the auditor performs to test and evaluate design effectiveness include inquiry, observation, walkthroughs, inspection of relevant documentation, and a specific evaluation of whether the controls are likely to prevent or detect errors or fraud that could result in misstatements if they are operated as prescribed by appropriately qualified persons.

90. The procedures that the auditor performs in evaluating management's assessment process and obtaining an understanding of internal control over financial reporting also provide the auditor with evidence about the design effectiveness of internal control over financial reporting.

91. The procedures the auditor performs to test and evaluate design effectiveness also might provide evidence about operating effectiveness.

Testing and Evaluating Operating Effectiveness

92. An auditor should evaluate the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and qualifications to perform the control effectively.

93. *Nature of Tests of Controls*. Tests of controls over operating effectiveness should include a mix of inquiries of appropriate personnel, inspection of relevant documentation, observation of the company's operations, and reperformance of the application of the control. For example, the auditor might observe the procedures for opening the mail and processing cash receipts to test the operating effectiveness of controls over cash receipts. Because an observation is pertinent only at the point in time at which it is made, the auditor should supplement the observation with inquiries of company personnel and inspection of documentation about the operation of such controls at other times. These inquiries might be made concurrently with performing walkthroughs.

94. Inquiry is a procedure that consists of seeking information, both financial and nonfinancial, of knowledgeable persons throughout the company. Inquiry is used extensively throughout the audit and often is complementary to performing other procedures. Inquiries may range from formal written inquiries to informal oral inquiries.

95. Evaluating responses to inquiries is an integral part of the inquiry procedure. Examples of information that inquiries might provide include the skill and competency of those performing the control, the relative sensitivity of the control to prevent or detect errors or fraud, and the frequency with which the control operates to prevent or detect errors or fraud. Responses to inquiries might provide the auditor with information not previously possessed or with corroborative evidence. Alternatively, responses might provide information that differs significantly from other information the auditor obtains (for example, information regarding the possibility of management override of controls). In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional procedures.

96. Because inquiry alone does not provide sufficient evidence to support the operating effectiveness of a control, the auditor should perform additional tests of controls. For example, if the company implements a control activity whereby its sales manager reviews and investigates a report of invoices with unusually high or low gross margins, inquiry of the sales manager as to whether he or she investigates discrepancies would be inadequate. To obtain sufficient evidence about the operating effectiveness of the control, the auditor should corroborate the sales manager's responses by performing other procedures, such as inspecting reports or other documentation used in or generated by the performance of the control, and evaluate whether appropriate actions were taken regarding discrepancies.

97. The nature of the control also influences the nature of the tests of controls the auditor can perform. For example, the auditor might examine documents regarding controls for which documentary evidence exists. However, documentary evidence regarding some aspects of the control environment, such as management's philosophy and operating style, might not exist. In circumstances in which documentary evidence of controls or the performance of controls does not exist and is not expected to exist, the auditor's tests of controls would consist of inquiries of appropriate personnel and observation of company activities. As another example, a signature on a voucher package to indicate that the signer approved it does not necessarily mean that the person carefully reviewed the package before signing. The package may have been signed based on only a cursory review (or without any review). As a result, the quality of the evidence regarding the effective operation of the control might not be sufficiently persuasive. If that is the case, the auditor should reperform the control (for example, checking prices, extensions, and additions) as part of the test of the control. In addition, the auditor might inquire of the person responsible for approving voucher packages what he or she looks for when approving packages and how many errors have been found within voucher packages. The auditor also might inquire of supervisors whether they have any knowledge of errors that the person responsible for approving the voucher packages failed to detect.

98. *Timing of Tests of Controls*. The auditor must perform tests of controls over a period of time that is adequate to determine whether, as of the date specified in management's report, the controls necessary for achieving the objectives of the control criteria are operating effectively. The period of time over which the auditor performs tests of controls varies with the nature of the controls being tested and with the frequency with which specific controls operate and specific policies are applied. Some controls operate continuously (for example, controls over sales), while others operate only at certain times (for example, controls over the preparation of monthly or quarterly financial statements and controls over physical inventory counts).

99. The auditor's testing of the operating effectiveness of such controls should occur at the time the controls are operating. Controls "as of" a specific date encompass controls that are relevant to the company's internal control over financial reporting "as of" that specific date, even though such controls might not operate until after that specific date. For example, some controls over the period-end financial reporting process normally operate only after the "as of" date. Therefore, if controls over the December 31, 20X4 period-end financial reporting process operate in January 20X5, the auditor should test the control operating in January 20X5 to have sufficient evidence of operating effectiveness "as of" December 31, 20X4.

100. When the auditor reports on the effectiveness of controls "as of" a specific date and obtains evidence about the operating effectiveness of controls at an interim date, he or she should determine what additional evidence to obtain concerning the operation of the control for the remaining period. In making that determination, the auditor should evaluate:

- The specific controls tested prior to the "as of" date and the results of those tests;
- The degree to which evidence about the operating effectiveness of those controls was obtained;
- The length of the remaining period; and
- The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date.

101. For controls over significant nonroutine transactions, controls over accounts or processes with a high degree of subjectivity or judgment in measurement, or controls over the recording of period-end adjustments, the auditor should perform tests of controls closer to or at the "as of" date rather than at an interim date. However, the auditor should balance performing the tests of controls closer to the "as of" date with the need to obtain sufficient evidence of operating effectiveness.

102. Prior to the date specified in management's report, management might implement changes to the company's controls to make them more effective or efficient or to address control deficiencies. In that case, the auditor might not need to evaluate controls that have been superseded. For example, if the auditor determines that the new controls achieve the related objectives of the control criteria and have been in effect for a sufficient period to permit the auditor to assess their design and operating effectiveness by performing tests of

controls,[15/] he or she will not need to evaluate the design and operating effectiveness of the superseded controls for purposes of expressing an opinion on internal control over financial reporting.

103. As discussed in paragraph 207, however, the auditor must communicate all identified significant deficiencies and material weaknesses in controls to the audit committee in writing. In addition, the auditor should evaluate how the design and operating effectiveness of the superseded controls relates to the auditor's reliance on controls for financial statement audit purposes.

104. *Extent of Tests of Controls*. Each year the auditor must obtain sufficient evidence about whether the company's internal control over financial reporting, including the controls for all internal control components, is operating effectively. This means that each year the auditor must obtain evidence about the effectiveness of controls for all relevant assertions related to all significant accounts and disclosures in the financial statements. The auditor also should vary from year to year the nature, timing, and extent of testing of controls to introduce unpredictability into the testing and respond to changes in circumstances. For example, each year the auditor might test the controls at a different interim period; increase or reduce the number and types of tests performed; or change the combination of procedures used.

105. In determining the extent of procedures to perform, the auditor should design the procedures to provide a high level of assurance that the control being tested is operating effectively. In making this determination, the auditor should assess the following factors:

- *Nature of the control*. The auditor should subject manual controls to more extensive testing than automated controls. In some circumstances, testing a single operation of an automated control may be sufficient to obtain a high level of assurance that the control operated effectively, provided that information technology general controls also are operating effectively. For manual controls, sufficient evidence about the operating effectiveness of the controls is obtained by evaluating multiple operations of the control and the results of each operation. The auditor also should assess the complexity of the controls, the significance of the judgments that must be made in connection with their operation, and the level of competence of the person performing the controls that is necessary for the control to operate effectively. As the complexity and level of judgment increase or the level of competence of the person

[15/] Paragraph 179 provides reporting directions in these circumstances when the auditor has not been able to obtain evidence that the new controls were appropriately designed or have been operating effectively for a sufficient period of time.

performing the control decreases, the extent of the auditor's testing should increase.

- *Frequency of operation*. Generally, the more frequently a manual control operates, the more operations of the control the auditor should test. For example, for a manual control that operates in connection with each transaction, the auditor should test multiple operations of the control over a sufficient period of time to obtain a high level of assurance that the control operated effectively. For controls that operate less frequently, such as monthly account reconciliations and controls over the period-end financial reporting process, the auditor may test significantly fewer operations of the control. However, the auditor's evaluation of each operation of controls operating less frequently is likely to be more extensive. For example, when evaluating the operation of a monthly exception report, the auditor should evaluate whether the judgments made with regard to the disposition of the exceptions were appropriate and adequately supported.

  Note: When sampling is appropriate and the population of controls to be tested is large, increasing the population size does not proportionately increase the required sample size.

- *Importance of the control*. Controls that are relatively more important should be tested more extensively. For example, some controls may address multiple financial statement assertions, and certain period-end detective controls might be considered more important than related preventive controls. The auditor should test more operations of such controls or, if such controls operate infrequently, the auditor should evaluate each operation of the control more extensively.

106. *Use of Professional Skepticism when Evaluating the Results of Testing*. The auditor must conduct the audit of internal control over financial reporting and the audit of the financial statements with professional skepticism, which is an attitude that includes a questioning mind and a critical assessment of audit evidence. For example, even though a control is performed by the same employee whom the auditor believes performed the control effectively in prior periods, the control may not be operating effectively during the current period because the employee could have become complacent, distracted, or otherwise not be effectively carrying out his or her responsibilities. Also, regardless of any past experience with the entity or the auditor's beliefs about management's honesty and integrity, the auditor should recognize the possibility that a material misstatement due to fraud could be present. Furthermore, professional skepticism requires the auditor to consider whether evidence obtained suggests that a material misstatement due to fraud has occurred. In exercising

professional skepticism in gathering and evaluating evidence, the auditor must not be satisfied with less-than-persuasive evidence because of a belief that management is honest.

107. When the auditor identifies exceptions to the company's prescribed control procedures, he or she should determine, using professional skepticism, the effect of the exception on the nature and extent of additional testing that may be appropriate or necessary and on the operating effectiveness of the control being tested. A conclusion that an identified exception does not represent a control deficiency is appropriate only if evidence beyond what the auditor had initially planned and beyond inquiry supports that conclusion.

Using the Work of Others

108. In all audits of internal control over financial reporting, the auditor must perform enough of the testing himself or herself so that the auditor's own work provides the principal evidence for the auditor's opinion. The auditor may, however, use the work of others to alter the nature, timing, or extent of the work he or she otherwise would have performed. For these purposes, the work of others includes relevant work performed by internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee that provides information about the effectiveness of internal control over financial reporting.

> Note: Because the amount of work related to obtaining sufficient evidence to support an opinion about the effectiveness of controls is not susceptible to precise measurement, the auditor's judgment about whether he or she has obtained the principal evidence for the opinion will be qualitative as well as quantitative. For example, the auditor might give more weight to work he or she performed on pervasive controls and in areas such as the control environment than on other controls, such as controls over low-risk, routine transactions.

109. The auditor should evaluate whether to use the work performed by others in the audit of internal control over financial reporting. To determine the extent to which the auditor may use the work of others to alter the nature, timing, or extent of the work the auditor would have otherwise performed, in addition to obtaining the principal evidence for his or her opinion, the auditor should:

a. Evaluate the nature of the controls subjected to the work of others (See paragraphs 112 through 116);

b. Evaluate the competence and objectivity of the individuals who performed the work (See paragraphs 117 through 122); and

c. Test some of the work performed by others to evaluate the quality and effectiveness of their work (See paragraphs 123 through 125).

Note: AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, applies to using the work of internal auditors in an audit of the financial statements. The auditor may apply the relevant concepts described in that section to using the work of others in the audit of internal control over financial reporting.

110. The auditor must obtain sufficient evidence to support his or her opinion. Judgments about the sufficiency of evidence obtained and other factors affecting the auditor's opinion, such as the significance of identified control deficiencies, should be those of the auditor. Evidence obtained through the auditor's direct personal knowledge, observation, reperformance, and inspection is generally more persuasive than information obtained indirectly from others, such as from internal auditors, other company personnel, or third parties working under the direction of management.

111. The requirement that the auditor's own work must provide the principal evidence for the auditor's opinion is one of the boundaries within which the auditor determines the work he or she must perform himself or herself in the audit of internal control over financial reporting. Paragraphs 112 through 125 provide more specific and definitive direction on how the auditor makes this determination, but the directions allow the auditor significant flexibility to use his or her judgment to determine the work necessary to obtain the principal evidence and to determine when the auditor can use the work of others rather than perform the work himself or herself. Regardless of the auditor's determination of the work that he or she must perform himself or herself, the auditor's responsibility to report on the effectiveness of internal control over financial reporting rests solely with the auditor; this responsibility cannot be shared with the other individuals whose work the auditor uses. Therefore, when the auditor uses the work of others, the auditor is responsible for the results of their work.

112. *Evaluating the Nature of the Controls Subjected to the Work of Others*. The auditor should evaluate the following factors when evaluating the nature of the controls subjected to the work of others. As these factors increase in significance, the need for the auditor to perform his or her own work on those controls increases. As these factors decrease in significance, the need for the auditor to perform his or her own work on those controls decreases.

- The materiality of the accounts and disclosures that the control addresses and the risk of material misstatement.

- The degree of judgment required to evaluate the operating effectiveness of the control (that is, the degree to which the evaluation of the effectiveness of the control requires evaluation of subjective factors rather than objective testing).

- The pervasiveness of the control.

- The level of judgment or estimation required in the account or disclosure.

- The potential for management override of the control.

113. Because of the nature of the controls in the control environment, the auditor should not use the work of others to reduce the amount of work he or she performs on controls in the control environment. The auditor should, however, consider the results of work performed in this area by others because it might indicate the need for the auditor to increase his or her work.

114. The control environment encompasses the following factors:[16/]

- Integrity and ethical values;

- Commitment to competence;

- Board of directors or audit committee participation;

- Management's philosophy and operating style;

- Organizational structure;

- Assignment of authority and responsibility; and

- Human resource policies and procedures.

115. Controls that are part of the control environment include, but are not limited to, controls specifically established to prevent and detect fraud that is at least reasonably possible to result in material misstatement of the financial statements.

Note: The term "reasonably possible" has the same meaning as in FAS No. 5. See the first note to paragraph 9 for further discussion.

116. The auditor should perform the walkthroughs (as discussed beginning at paragraph 79) himself or herself because of the degree of judgment required in

16/ See the COSO report and paragraph .110 of AU sec. 319, *Internal Control in a Financial Statement Audit*, for additional information about the factors included in the control environment.

performing this work. However, to provide additional evidence, the auditor may also review the work of others who have performed and documented walkthroughs. In evaluating whether his or her own evidence provides the principal evidence, the auditor's work on the control environment and in performing walkthroughs constitutes an important part of the auditor's own work.

117. *Evaluating the Competence and Objectivity of Others*. The extent to which the auditor may use the work of others depends on the degree of competence and objectivity of the individuals performing the work. The higher the degree of competence and objectivity, the greater use the auditor may make of the work; conversely, the lower the degree of competence and objectivity, the less use the auditor may make of the work. Further, the auditor should not use the work of individuals who have a low degree of objectivity, regardless of their level of competence. Likewise, the auditor should not use the work of individuals who have a low level of competence regardless of their degree of objectivity.

118. When evaluating the competence and objectivity of the individuals performing the tests of controls, the auditor should obtain, or update information from prior years, about the factors indicated in the following paragraph. The auditor should determine whether to test the existence and quality of those factors and, if so, the extent to which to test the existence and quality of those factors, based on the intended effect of the work of others on the audit of internal control over financial reporting.

119. Factors concerning the competence of the individuals performing the tests of controls include:

- Their educational level and professional experience.
- Their professional certification and continuing education.
- Practices regarding the assignment of individuals to work areas.
- Supervision and review of their activities.
- Quality of the documentation of their work, including any reports or recommendations issued.
- Evaluation of their performance.

120. Factors concerning the objectivity of the individuals performing the tests of controls include:

- The organizational status of the individuals responsible for the work of others ("testing authority") in testing controls, including—

a. Whether the testing authority reports to an officer of sufficient status to ensure sufficient testing coverage and adequate consideration of, and action on, the findings and recommendations of the individuals performing the testing.

b. Whether the testing authority has direct access and reports regularly to the board of directors or the audit committee.

c. Whether the board of directors or the audit committee oversees employment decisions related to the testing authority.

- Policies to maintain the individuals' objectivity about the areas being tested, including—

a. Policies prohibiting individuals from testing controls in areas in which relatives are employed in important or internal control-sensitive positions.

b. Policies prohibiting individuals from testing controls in areas to which they were recently assigned or are scheduled to be assigned upon completion of their controls testing responsibilities.

121. Internal auditors normally are expected to have greater competence with regard to internal control over financial reporting and objectivity than other company personnel. Therefore, the auditor may be able to use their work to a greater extent than the work of other company personnel. This is particularly true in the case of internal auditors who follow the *International Standards for the Professional Practice of Internal Auditing* issued by the Institute of Internal Auditors. If internal auditors have performed an extensive amount of relevant work and the auditor determines they possess a high degree of competence and objectivity, the auditor could use their work to the greatest extent an auditor could use the work of others. On the other hand, if the internal audit function reports solely to management, which would reduce internal auditors' objectivity, or if limited resources allocated to the internal audit function result in very limited testing procedures on its part or reduced competency of the internal auditors, the auditor should use their work to a much lesser extent and perform more of the testing himself or herself.

122. When determining how the work of others will alter the nature, timing, or extent of the auditor's work, the auditor should assess the interrelationship of the nature of the controls, as discussed in paragraph 112, and the competence and objectivity of those who performed the work, as discussed in paragraphs 117 through 121. As the significance of the factors listed in paragraph 112 increases, the ability of the auditor to use the work of others decreases at the same time

that the necessary level of competence and objectivity of those who perform the work increases. For example, for some pervasive controls, the auditor may determine that using the work of internal auditors to a limited degree would be appropriate and that using the work of other company personnel would not be appropriate because other company personnel do not have a high enough degree of objectivity as it relates to the nature of the controls.

123. *Testing the Work of Others*. The auditor should test some of the work of others to evaluate the quality and effectiveness of the work. The auditor's tests of the work of others may be accomplished by either (a) testing some of the controls that others tested or (b) testing similar controls not actually tested by others.

124. The nature and extent of these tests depend on the effect of the work of others on the auditor's procedures but should be sufficient to enable the auditor to make an evaluation of the overall quality and effectiveness of the work the auditor is considering. The auditor also should assess whether this evaluation has an effect on his or her conclusions about the competence and objectivity of the individuals performing the work.

125. In evaluating the quality and effectiveness of the work of others, the auditor should evaluate such factors as to whether the:

- Scope of work is appropriate to meet the objectives.
- Work programs are adequate.
- Work performed is adequately documented, including evidence of supervision and review.
- Conclusions are appropriate in the circumstances.
- Reports are consistent with the results of the work performed.

126. The following examples illustrate how to apply the directions discussed in this section:

- *Controls over the period-end financial reporting process*. Many of the controls over the period-end financial reporting process address significant risks of misstatement of the accounts and disclosures in the annual and quarterly financial statements, may require significant judgment to evaluate their operating effectiveness, may have a higher potential for management override, and may affect accounts that require a high level of judgment or estimation. Therefore, the auditor could determine that, based on the nature of controls over the period-end financial reporting process, he or she would need to perform more of the tests of those controls himself or herself. Further, because of the nature of the controls, the auditor should use the work of others only if the degree of competence and objectivity of the individuals performing the work is high; therefore, the auditor might use the work of internal auditors to some extent but not the work of others within the company.

- *Information technology general controls*. Information technology general controls are part of the control activities component of internal control; therefore, the nature of the controls might permit the auditor to use the work of others. For example, program change controls over routine maintenance changes may have a highly pervasive effect, yet involve a low degree of judgment in evaluating their operating effectiveness, can be subjected to objective testing, and have a low potential for management override. Therefore, the auditor could determine that, based on the nature of these program change controls, the auditor could use the work of others to a moderate extent so long as the degree of competence and objectivity of the individuals performing the test is at an appropriate level. On the other hand, controls to detect attempts to override controls that prevent unauthorized journal entries from being posted may have a highly pervasive effect, may involve a high degree of judgment in evaluating their operating effectiveness, may involve a subjective evaluation, and may have a reasonable possibility for management override. Therefore, the auditor could determine that, based on the nature of these controls over systems access, he or she would need to perform more of the tests of those controls himself or herself. Further, because of the nature of the controls, the auditor should use the work of others only if the degree of competence and objectivity of the individuals performing the tests is high.

- *Management self-assessment of controls*. As described in paragraph 40, management may test the operating effectiveness of controls using a self-assessment process. Because such an assessment is made by the same personnel who are responsible for performing the control, the individuals performing the self-assessment do not have sufficient objectivity as it relates to the subject matter. Therefore, the auditor should not use their work.

- *Controls over the calculation of depreciation of fixed assets*. Controls over the calculation of depreciation of fixed assets are usually not pervasive, involve a low degree of judgment in evaluating their operating effectiveness, and can be subjected to objective testing. If these conditions describe the controls over the calculation of depreciation of fixed assets and if there is a low potential for management override, the auditor could determine that, based on the nature of these controls, the auditor could use the work of others to a large extent (perhaps entirely) so long as the degree of competence and objectivity of the individuals performing the test is at an appropriate level.

- *Alternating tests of controls*. Many of the controls over accounts payable, including controls over cash disbursements, are usually not pervasive, involve a low degree of judgment in evaluating their operating effectiveness, can be subjected to objective testing, and have a low potential for management override. When these conditions describe the controls over accounts payable, the auditor could determine that, based on the nature of these controls, he or she could use the work of others to a large extent (perhaps entirely) so long as the degree of competence and objectivity of the individuals performing the test is at an appropriate level. However, if the company recently implemented a major information technology change that significantly affected controls over cash disbursements, the auditor might decide to use the work of others to a lesser extent in the audit immediately following the information technology change and then return, in subsequent years, to using the work of others to a large extent in this area. As another example, the auditor might use the work of others for testing controls over the depreciation of fixed assets (as described in the point above) for several years' audits but decide one year to perform some extent of the work himself or herself to gain an understanding of these controls beyond that provided by performing a walkthrough.

Forming an Opinion on the Effectiveness of Internal Control Over Financial Reporting

127. When forming an opinion on internal control over financial reporting, the auditor should evaluate all evidence obtained from all sources, including:

- The adequacy of the assessment performed by management and the results of the auditor's evaluation of the design and tests of operating effectiveness of controls;

- The negative results of substantive procedures performed during the financial statement audit (for example, recorded and unrecorded adjustments identified as a result of the performance of the auditing procedures); and

- Any identified control deficiencies.

128. As part of this evaluation, the auditor should review all reports issued during the year by internal audit (or similar functions, such as loan review in a financial institution) that address controls related to internal control over financial reporting and evaluate any control deficiencies identified in those reports. This review should include reports issued by internal audit as a result of operational audits or specific reviews of key processes if those reports address controls related to internal control over financial reporting.

129. *Issuing an Unqualified Opinion*. The auditor may issue an unqualified opinion only when there are no identified material weaknesses and when there have been no restrictions on the scope of the auditor's work. The existence of a material weakness requires the auditor to express an adverse opinion on the effectiveness of internal control over financial reporting (See paragraph 175), while a scope limitation requires the auditor to express a qualified opinion or a disclaimer of opinion, depending on the significance of the limitation in scope (See paragraph 178).

130. *Evaluating Deficiencies in Internal Control Over Financial Reporting*. The auditor must evaluate identified control deficiencies and determine whether the deficiencies, individually or in combination, are significant deficiencies or material weaknesses. The evaluation of the significance of a deficiency should include both quantitative and qualitative factors.

131. The auditor should evaluate the significance of a deficiency in internal control over financial reporting initially by determining the following:

- The likelihood that a deficiency, or a combination of deficiencies, could result in a misstatement of an account balance or disclosure; and

- The magnitude of the potential misstatement resulting from the deficiency or deficiencies.

132. The significance of a deficiency in internal control over financial reporting depends on the *potential* for a misstatement, not on whether a misstatement actually has occurred.

133. Several factors affect the *likelihood* that a deficiency, or a combination of deficiencies, could result in a misstatement of an account balance or disclosure. The factors include, but are not limited to, the following:

- The nature of the financial statement accounts, disclosures, and assertions involved; for example, suspense accounts and related party transactions involve greater risk.

- The susceptibility of the related assets or liability to loss or fraud; that is, greater susceptibility increases risk.

- The subjectivity, complexity, or extent of judgment required to determine the amount involved; that is, greater subjectivity, complexity, or judgment, like that related to an accounting estimate, increases risk.

- The cause and frequency of known or detected exceptions for the operating effectiveness of a control; for example, a control with an observed non-negligible deviation rate is a deficiency.

- The interaction or relationship of the control with other controls; that is, the interdependence or redundancy of the control.

- The interaction of the deficiencies; for example, when evaluating a combination of two or more deficiencies, whether the deficiencies could affect the same financial statement accounts and assertions.

- The possible future consequences of the deficiency.

134. When evaluating the likelihood that a deficiency or combination of deficiencies could result in a misstatement, the auditor should evaluate how the controls interact with other controls. There are controls, such as information technology general controls, on which other controls depend. Some controls function together as a group of controls. Other controls overlap, in the sense that these other controls achieve the same objective.

135. Several factors affect the magnitude of the misstatement that could result from a deficiency or deficiencies in controls. The factors include, but are not limited to, the following:

- The financial statement amounts or total of transactions exposed to the deficiency.

- The volume of activity in the account balance or class of transactions exposed to the deficiency that has occurred in the current period or that is expected in future periods.

136. In evaluating the magnitude of the potential misstatement, the auditor should recognize that the maximum amount that an account balance or total of transactions can be overstated is generally the recorded amount. However, the recorded amount is not a limitation on the amount of potential understatement. The auditor also should recognize that the risk of misstatement might be different for the maximum possible misstatement than for lesser possible amounts.

137. When evaluating the significance of a deficiency in internal control over financial reporting, the auditor also should determine the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles. If the auditor determines that the deficiency would prevent prudent officials in the conduct of their own affairs from concluding that they have reasonable assurance,[17/] then the auditor should deem the deficiency to be at least a significant deficiency. Having determined in this manner that a deficiency represents a significant deficiency, the auditor must further evaluate the deficiency to determine whether individually, or in combination with other deficiencies, the deficiency is a material weakness.

> Note: Paragraphs 9 and 10 provide the definitions of significant deficiency and material weakness, respectively.

138. Inadequate documentation of the design of controls and the absence of sufficient documented evidence to support management's assessment of the operating effectiveness of internal control over financial reporting are control deficiencies. As with other control deficiencies, the auditor should evaluate these deficiencies as to their significance.

139. The interaction of qualitative considerations that affect internal control over financial reporting with quantitative considerations ordinarily results in deficiencies in the following areas being at least significant deficiencies in internal control over financial reporting:

- Controls over the selection and application of accounting policies that are in conformity with generally accepted accounting principles;
- Antifraud programs and controls;
- Controls over non-routine and non-systematic transactions; and
- Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; initiate, authorize, record, and process journal entries into the general ledger; and record recurring and nonrecurring adjustments to the financial statements

[17/] See SEC Staff Accounting Bulletin Topic 1M2, *Immaterial Misstatements That Are Intentional*, for further discussion about the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs.

140. Each of the following circumstances should be regarded as at least a significant deficiency and as a strong indicator that a material weakness in internal control over financial reporting exists:

- Restatement of previously issued financial statements to reflect the correction of a misstatement.

  Note: The correction of a misstatement includes misstatements due to error or fraud; it does not include restatements to reflect a change in accounting principle to comply with a new accounting principle or a voluntary change from one generally accepted accounting principle to another generally accepted accounting principle.

- Identification by the auditor of a material misstatement in financial statements in the current period that was not initially identified by the company's internal control over financial reporting. (This is a strong indicator of a material weakness even if management subsequently corrects the misstatement.)

- Oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective. (Paragraphs 55 through 59 present factors to evaluate when determining whether the audit committee is ineffective.)

- The internal audit function or the risk assessment function is ineffective at a company for which such a function needs to be effective for the company to have an effective monitoring or risk assessment component, such as for very large or highly complex companies.

  Note: The evaluation of the internal audit or risk assessment functions is similar to the evaluation of the audit committee, as described in paragraphs 55 through 59, that is, the evaluation is made within the context of the monitoring and risk assessment components. The auditor is not required to make a separate evaluation of the effectiveness and performance of these functions. Instead, the auditor should base his or her evaluation on evidence obtained as part of evaluating the monitoring and risk assessment components of internal control over financial reporting.

- For complex entities in highly regulated industries, an ineffective regulatory compliance function. This relates solely to those aspects of the ineffective regulatory compliance function in which associated violations of laws and regulations could have a material effect on the reliability of financial reporting.

- Identification of fraud of any magnitude on the part of senior management.

  Note: The auditor is required to plan and perform procedures to obtain reasonable assurance that material misstatement caused by fraud is detected by the auditor. However, for the purposes of evaluating and reporting deficiencies in internal control over financial reporting, the auditor should evaluate fraud of any magnitude (including fraud resulting in immaterial misstatements) on the part of senior management of which he or she is aware. Furthermore, for the purposes of this circumstance, "senior management" includes the principal executive and financial officers signing the company's certifications as required under Section 302 of the Act as well as any other member of management who play a significant role in the company's financial reporting process.

- Significant deficiencies that have been communicated to management and the audit committee remain uncorrected after some reasonable period of time.

- An ineffective control environment.

141. Appendix D provides examples of significant deficiencies and material weaknesses.

Requirement for Written Representations

142. In an audit of internal control over financial reporting, the auditor should obtain written representations from management:

a. Acknowledging management's responsibility for establishing and maintaining effective internal control over financial reporting;

b. Stating that management has performed an assessment of the effectiveness of the company's internal control over financial reporting and specifying the control criteria;

c. Stating that management did not use the auditor's procedures performed during the audits of internal control over financial reporting or the financial statements as part of the basis for management's assessment of the effectiveness of internal control over financial reporting;

d. Stating management's conclusion about the effectiveness of the company's internal control over financial reporting based on the control criteria as of a specified date;

e. Stating that management has disclosed to the auditor all deficiencies in the design or operation of internal control over financial reporting identified as part of management's assessment, including separately disclosing to the auditor all such deficiencies that it believes to be significant deficiencies or material weaknesses in internal control over financial reporting;

f. Describing any material fraud and any other fraud that, although not material, involves senior management or management or other employees who have a significant role in the company's internal control over financial reporting;

g. Stating whether control deficiencies identified and communicated to the audit committee during previous engagements pursuant to paragraph 207 have been resolved, and specifically identifying any that have not; and

h. Stating whether there were, subsequent to the date being reported on, any changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses.

143. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion. As discussed further in paragraph 178, when management limits the scope of the audit, the auditor should either withdraw from the engagement or disclaim an opinion. Further, the auditor should evaluate the effects of management's refusal on his or her ability to rely on other representations, including, if applicable, representations obtained in an audit of the company's financial statements.

144. AU sec. 333, *Management Representations*, explains matters such as who should sign the letter, the period to be covered by the letter, and when to obtain an updating letter.

Relationship of an Audit of Internal Control over Financial Reporting to an Audit of Financial Statements

145. The audit of internal control over financial reporting should be integrated with the audit of the financial statements. The objectives of the procedures for

the audits are not identical, however, and the auditor must plan and perform the work to achieve the objectives of both audits.

146. The understanding of internal control over financial reporting the auditor obtains and the procedures the auditor performs for purposes of expressing an opinion on management's assessment are interrelated with the internal control over financial reporting understanding the auditor obtains and procedures the auditor performs to assess control risk for purposes of expressing an opinion on the financial statements. As a result, it is efficient for the auditor to coordinate obtaining the understanding and performing the procedures.

Tests of Controls in an Audit of Internal Control Over Financial Reporting

147. The objective of the tests of controls in an audit of internal control over financial reporting is to obtain evidence about the effectiveness of controls to support the auditor's opinion on whether management's assessment of the effectiveness of the company's internal control over financial reporting is fairly stated. The auditor's opinion relates to the effectiveness of the company's internal control over financial reporting as of a *point in time* and *taken as a whole*.

148. To express an opinion on internal control over financial reporting effectiveness as of a *point in time*, the auditor should obtain evidence that internal control over financial reporting has operated effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the company's financial statements. To express an opinion on internal control over financial reporting effectiveness *taken as a whole*, the auditor must obtain evidence about the effectiveness of controls over all relevant assertions related to all significant accounts and disclosures in the financial statements. This requires that the auditor test the design and operating effectiveness of controls he or she ordinarily would not test if expressing an opinion only on the financial statements.

149. When concluding on the effectiveness of internal control over financial reporting for purposes of expressing an opinion on management's assessment, the auditor should incorporate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the financial statements, as discussed in the following section.

Tests of Controls in an Audit of Financial Statements

150. To express an opinion on the financial statements, the auditor ordinarily performs tests of controls and substantive procedures. The objective of the tests of controls the auditor performs for this purpose is to assess control risk. To assess control risk for specific financial statement assertions at less than the maximum, the auditor is required to obtain evidence that the relevant controls operated effectively during the *entire period* upon which the auditor plans to

place reliance on those controls. However, the auditor is not required to assess control risk at less than the maximum for *all* relevant assertions and, for a variety of reasons, the auditor may choose not to do so.[18/]

151. When concluding on the effectiveness of controls for the purpose of assessing control risk, the auditor also should evaluate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on management's assessment, as discussed in paragraphs 147 through 149. Consideration of these results may require the auditor to alter the nature, timing, and extent of substantive procedures and to plan and perform further tests of controls, particularly in response to identified control deficiencies.

Effect of Tests of Controls on Substantive Procedures

152. Regardless of the assessed level of control risk or the assessed risk of material misstatement in connection with the audit of the financial statements, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures. Performing procedures to express an opinion on internal control over financial reporting does not diminish this requirement.

153. The substantive procedures that the auditor should perform consist of tests of details of transactions and balances and analytical procedures. Before using the results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information. For significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.

154. When designing substantive analytical procedures, the auditor also should evaluate the risk of management override of controls. As part of this process, the auditor should evaluate whether such an override might have allowed adjustments outside of the normal period-end financial reporting process to have been made to the financial statements. Such adjustments might have resulted in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions. For this reason, substantive analytical procedures alone are not well suited to detecting fraud.

155. The auditor's substantive procedures must include reconciling the financial statements to the accounting records. The auditor's substantive procedures also should include examining material adjustments made during the course of

18/ See paragraph 160 for additional documentation requirements when the auditor assesses control risk as other than low.

preparing the financial statements. Also, other auditing standards require auditors to perform specific tests of details in the financial statement audit. For instance, AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to perform certain tests of details to further address the risk of management override, whether or not a specific risk of fraud has been identified. Paragraph .34 of AU Sec. 330, *The Confirmation Process*, states that there is a presumption that the auditor will request the confirmation of accounts receivable. Similarly, paragraph .01 of AU Sec. 331, *Inventories*, states that observation of inventories is a generally accepted auditing procedure and that the auditor who issues an opinion without this procedure "has the burden of justifying the opinion expressed."

156. If, during the audit of internal control over financial reporting, the auditor identifies a control deficiency, he or she should determine the effect on the nature, timing, and extent of substantive procedures to be performed to reduce the risk of material misstatement of the financial statements to an appropriately low level.

Effect of Substantive Procedures on the Auditor's Conclusions About the Operating Effectiveness of Controls

157. In an audit of internal control over financial reporting, the auditor should evaluate the effect of the findings of all substantive auditing procedures performed in the audit of financial statements on the effectiveness of internal control over financial reporting. This evaluation should include, but not be limited to:

- The auditor's risk evaluations in connection with the selection and application of substantive procedures, especially those related to fraud (See paragraph 26);
- Findings with respect to illegal acts and related party transactions;
- Indications of management bias in making accounting estimates and in selecting accounting principles; and
- Misstatements detected by substantive procedures. The extent of such misstatements might alter the auditor's judgment about the effectiveness of controls.

158. However, the absence of misstatements detected by substantive procedures does not provide evidence that controls related to the assertion being tested are effective.

Documentation Requirements

159. In addition to the documentation requirements in AU sec. 339, *Audit Documentation*, the auditor should document:

- The understanding obtained and the evaluation of the design of each of the five components of the company's internal control over financial reporting;
- The process used to determine significant accounts and disclosures and major classes of transactions, including the determination of the locations or business units at which to perform testing;
- The identification of the points at which misstatements related to relevant financial statement assertions could occur within significant accounts and disclosures and major classes of transactions;
- The extent to which the auditor relied upon work performed by others as well as the auditor's assessment of their competence and objectivity;
- The evaluation of any deficiencies noted as a result of the auditor's testing; and
- Other findings that could result in a modification to the auditor's report.

160. For a company that has effective internal control over financial reporting, the auditor ordinarily will be able to perform sufficient testing of controls to be able to assess control risk for all relevant assertions related to significant accounts and disclosures at a low level. If, however, the auditor assesses control risk as other than low for certain assertions or significant accounts, the auditor should document the reasons for that conclusion. Examples of when it is appropriate to assess control risk as other than low include:

- When a control over a relevant assertion related to a significant account or disclosure was superseded late in the year and only the new control was tested for operating effectiveness.
- When a material weakness existed during the period under audit and was corrected by the end of the period.

161. The auditor also should document the effect of a conclusion that control risk is other than low for any relevant assertions related to any significant

accounts in connection with the audit of the financial statements on his or her opinion on the audit of internal control over financial reporting.

Reporting on Internal Control Over Financial Reporting

Management's Report

162. Management is required to include in its annual report its assessment of the effectiveness of the company's internal control over financial reporting in addition to its audited financial statements as of the end of the most recent fiscal year. Management's report on internal control over financial reporting is required to include the following:[19/]

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company;

- A statement identifying the framework used by management to conduct the required assessment of the effectiveness of the company's internal control over financial reporting;

- An assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including an explicit statement as to whether that internal control over financial reporting is effective; and

- A statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the company's internal control over financial reporting.

163. Management should provide, both in its report on internal control over financial reporting and in its representation letter to the auditor, a written conclusion about the effectiveness of the company's internal control over financial reporting. The conclusion about the effectiveness of a company's internal control over financial reporting can take many forms; however, management is required to state a direct conclusion about whether the company's internal control over financial reporting is effective. This standard, for example, includes the phrase "management's assessment that W Company maintained effective internal control over financial reporting as of [*date*]" to illustrate such a conclusion. Other phrases, such as "management's assessment that W Company's internal control over financial reporting as of [*date*] is sufficient to meet the stated objectives," also might be used. However, the conclusion

[19/] See Item 308(a) of Regulation S-B and S-K, 17 C.F.R. 228.308(a) and 17 C.F.R. 229.308(a), respectively.

should not be so subjective (for example, "very effective internal control") that people having competence in and using the same or similar criteria would not ordinarily be able to arrive at similar conclusions.

164. Management is precluded from concluding that the company's internal control over financial reporting is effective if there are one or more material weaknesses.[20/] In addition, management is required to disclose all material weaknesses that exist as of the end of the most recent fiscal year.

165. Management might be able to accurately represent that internal control over financial reporting, as of the end of the company's most recent fiscal year, is effective even if one or more material weaknesses existed during the period. To make this representation, management must have changed the internal control over financial reporting to eliminate the material weaknesses sufficiently in advance of the "as of" date and have satisfactorily tested the effectiveness over a period of time that is adequate for it to determine whether, as of the end of the fiscal year, the design and operation of internal control over financial reporting is effective.[21/]

Auditor's Evaluation of Management's Report

166. With respect to management's report on its assessment, the auditor should evaluate the following matters:

a. Whether management has properly stated its responsibility for establishing and maintaining adequate internal control over financial reporting.

b. Whether the framework used by management to conduct the evaluation is suitable. (As discussed in paragraph 14, the framework described in COSO constitutes a suitable and available framework.)

[20] See Item 308(a)(3) of Regulation S-B and S-K, 17 C.F.R. 228.308(a) and 17 C.F.R. 229.308(a), respectively.

[21] However, when the reason for a change in internal control over financial reporting is the correction of a material weakness, management and the auditor should evaluate whether the reason for the change and the circumstances surrounding the change are material information necessary to make the disclosure about the change not misleading in a filing subject to certification under Securities Exchange Act Rule 13a-14(a) or 15d-14(a), 17 C.F.R. 240.13a-14(a) or 17 C.F.R. 240.15d-14(a). See discussion beginning at paragraph 200 for further direction.

c. Whether management's assessment of the effectiveness of internal control over financial reporting, as of the end of the company's most recent fiscal year, is free of material misstatement.

d. Whether management has expressed its assessment in an acceptable form.

– Management is required to state whether the company's internal control over financial reporting is effective.

– A negative assurance statement indicating that, "Nothing has come to management's attention to suggest that the company's internal control over financial reporting is not effective," is not acceptable.

– Management is not permitted to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses in the company's internal control over financial reporting.

e. Whether material weaknesses identified in the company's internal control over financial reporting, if any, have been properly disclosed, including material weaknesses corrected during the period.[22/]

Auditor's Report on Management's Assessment of Internal Control Over Financial Reporting

167. The auditor's report on management's assessment of the effectiveness of internal control over financial reporting must include the following elements:

a. A title that includes the word *independent*;

b. An identification of management's conclusion about the effectiveness of the company's internal control over financial reporting as of a specified date based on the control criteria [for example, criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)];

22/ See paragraph 206 for direction when a material weakness was corrected during the fourth quarter and the auditor believes that modification to the disclosures about changes in internal control over financial reporting are necessary for the annual certifications to be accurate and to comply with the requirements of Section 302 of the Act.

c. An identification of the title of the management report that includes management's assessment (the auditor should use the same description of the company's internal control over financial reporting as management uses in its report);

d. A statement that the assessment is the responsibility of management;

e. A statement that the auditor's responsibility is to express an opinion on the assessment and an opinion on the company's internal control over financial reporting based on his or her audit;

f. A definition of internal control over financial reporting as stated in paragraph 7;

g. A statement that the audit was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States);

h. A statement that the standards of the Public Company Accounting Oversight Board require that the auditor plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects;

i. A statement that an audit includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as the auditor considered necessary in the circumstances;

j. A statement that the auditor believes the audit provides a reasonable basis for his or her opinions;

k. A paragraph stating that, because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate;

l. The auditor's opinion on whether management's assessment of the effectiveness of the company's internal control over financial reporting as of the specified date is fairly stated, in all material respects, based on the control criteria (See discussion beginning at paragraph 162);

m. The auditor's opinion on whether the company maintained, in all material respects, effective internal control over financial reporting as of the specified date, based on the control criteria;

n. The manual or printed signature of the auditor's firm;

o. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued; and

p. The date of the audit report.

168. Example A-1 in Appendix A is an illustrative auditor's report for an unqualified opinion on management's assessment of the effectiveness of the company's internal control over financial reporting and an unqualified opinion on the effectiveness of the company's internal control over financial reporting.

169. *Separate or Combined Reports*. The auditor may choose to issue a combined report (that is, one report containing both an opinion on the financial statements and the opinions on internal control over financial reporting) or separate reports on the company's financial statements and on internal control over financial reporting. Example A-7 in Appendix A is an illustrative combined audit report on internal control over financial reporting. Appendix A also includes examples of separate reports on internal control over financial reporting.

170. If the auditor chooses to issue a separate report on internal control over financial reporting, he or she should add the following paragraph to the auditor's report on the financial statements:

> We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of W Company's internal control over financial reporting as of December 31, 20X3, based on [*identify control criteria*] and our report dated [*date of report, which should be the same as the date of the report on the financial statements*] expressed [*include nature of opinions*].

and add the following paragraph to the report on internal control over financial reporting:

> We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the effectiveness of*

internal control over financial reporting] expressed [*include nature of opinion*].

171. *Report Date*. As stated previously, the auditor cannot audit internal control over financial reporting without also auditing the financial statements. Therefore, the reports should be dated the same.

172. When the auditor elects to issue a combined report on the audit of the financial statements and the audit of internal control over financial reporting, the audit opinion will address multiple reporting periods for the financial statements presented but only the end of the most recent fiscal year for the effectiveness of internal control over financial reporting and management's assessment of the effectiveness of internal control over financial reporting. See a combined report in Example A-7 in Appendix A.

173. *Report Modifications*. The auditor should modify the standard report if any of the following conditions exist.

a. Management's assessment is inadequate or management's report is inappropriate. (See paragraph 174.)

b. There is a material weakness in the company's internal control over financial reporting. (See paragraphs 175 through 177.)

c. There is a restriction on the scope of the engagement. (See paragraphs 178 through 181.)

d. The auditor decides to refer to the report of other auditors as the basis, in part, for the auditor's own report. (See paragraphs 182 through 185.)

e. A significant subsequent event has occurred since the date being reported on. (See paragraphs 186 through 189.)

f. There is other information contained in management's report on internal control over financial reporting. (See paragraphs 190 through 192.)

174. *Management's Assessment Inadequate or Report Inappropriate*. If the auditor determines that management's process for assessing internal control over financial reporting is inadequate, the auditor should modify his or her opinion for a scope limitation (discussed further beginning at paragraph 178). If the auditor determines that management's report is inappropriate, the auditor should modify his or her report to include, at a minimum, an explanatory paragraph describing the reasons for this conclusion.

175. *Material Weaknesses*. Paragraphs 130 through 141 describe significant deficiencies and material weaknesses. If there are significant deficiencies that, individually or in combination, result in one or more material weaknesses, management is precluded from concluding that internal control over financial reporting is effective. In these circumstances, the auditor must express an adverse opinion on the company's internal control over financial reporting.

176. When expressing an adverse opinion on the effectiveness of internal control over financial reporting because of a material weakness, the auditor's report must include:

- The definition of a material weakness, as provided in paragraph 10.

- A statement that a material weakness has been identified and included in management's assessment. (If the material weakness has not been included in management's assessment, this sentence should be modified to state that the material weakness has been identified but not included in management's assessment. In this case, the auditor also is required to communicate in writing to the audit committee that the material weakness was not disclosed or identified as a material weakness in management's report.)

- A description of any material weaknesses identified in a company's internal control over financial reporting. This description should provide the users of the audit report with specific information about the nature of any material weakness, and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness. This description also should address requirements described in paragraph 194.

177. Depending on the circumstances, the auditor may express both an unqualified opinion and an other-than-unqualified opinion within the same report on internal control over financial reporting. For example, if management makes an adverse assessment because a material weakness has been identified and not corrected ("…internal control over financial reporting is not effective…"), the auditor would express an unqualified opinion on management's assessment ("…management's assessment that internal control over financial reporting is not effective is fairly stated, in all material respects…"). At the same time, the auditor would express an adverse opinion about the effectiveness of internal control over financial reporting ("In our opinion, because of the effect of the material weakness described…, the company's internal control over financial reporting is not effective."). Example A-2 in Appendix A illustrates the form of the report that is appropriate in this situation. Example A-6 in Appendix A illustrates a report that reflects disagreement between management and the auditor that a material weakness exists.

178. *Scope Limitations*. The auditor can express an unqualified opinion on management's assessment of internal control over financial reporting and an unqualified opinion on the effectiveness of internal control over financial reporting only if the auditor has been able to apply all the procedures necessary in the circumstances. If there are restrictions on the scope of the engagement imposed by the circumstances, the auditor should withdraw from the engagement, disclaim an opinion, or express a qualified opinion. The auditor's decision depends on his or her assessment of the importance of the omitted procedure(s) to his or her ability to form an opinion on management's assessment of internal control over financial reporting and an opinion on the effectiveness of the company's internal control over financial reporting. However, when the restrictions are imposed by management, the auditor should withdraw from the engagement or disclaim an opinion on management's assessment of internal control over financial reporting and the effectiveness of internal control over financial reporting.

179. For example, management might have identified a material weakness in its internal control over financial reporting prior to the date specified in its report and implemented controls to correct it. If management believes that the new controls have been operating for a sufficient period of time to determine that they are both effectively designed and operating, management would be able to include in its assessment its conclusion that internal control over financial reporting is effective as of the date specified. However, if the auditor disagrees with the sufficiency of the time period, he or she would be unable to obtain sufficient evidence that the new controls have been operating effectively for a sufficient period. In that case, the auditor should modify the opinion on the effectiveness of internal control over financial reporting and the opinion on management's assessment of internal control over financial reporting because of a scope limitation.

180. When the auditor plans to disclaim an opinion and the limited procedures performed by the auditor caused the auditor to conclude that a material weakness exists, the auditor's report should include:

- The definition of a material weakness, as provided in paragraph 10.

- A description of any material weaknesses identified in the company's internal control over financial reporting. This description should provide the users of the audit report with specific information about the nature of any material weakness, and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness. This description also should address the requirements in paragraph 194.

181. Example A-3 in Appendix A illustrates the form of report when there is a limitation on the scope of the audit causing the auditor to issue qualified opinions.

Example A-4 illustrates the form of report when restrictions on the scope of the audit cause the auditor to disclaim opinions.

182. *Opinions Based, in Part, on the Report of Another Auditor*. When another auditor has audited the financial statements and internal control over financial reporting of one or more subsidiaries, divisions, branches, or components of the company, the auditor should determine whether he or she may serve as the principal auditor and use the work and reports of another auditor as a basis, in part, for his or her opinions. AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, provides direction on the auditor's decision of whether to serve as the principal auditor of the financial statements. If the auditor decides it is appropriate to serve as the principal auditor of the financial statements, then that auditor also should be the principal auditor of the company's internal control over financial reporting. This relationship results from the requirement that an audit of the financial statements must be performed to audit internal control over financial reporting; only the principal auditor of the financial statements can be the principal auditor of internal control over financial reporting. In this circumstance, the principal auditor of the financial statements needs to participate sufficiently in the audit of internal control over financial reporting to provide a basis for serving as the principal auditor of internal control over financial reporting.

183. When serving as the principal auditor of internal control over financial reporting, the auditor should decide whether to make reference in the report on internal control over financial reporting to the audit of internal control over financial reporting performed by the other auditor. In these circumstances, the auditor's decision is based on factors similar to those of the independent auditor who uses the work and reports of other independent auditors when reporting on a company's financial statements as described in AU sec. 543.

184. The decision about whether to make reference to another auditor in the report on the audit of internal control over financial reporting might differ from the corresponding decision as it relates to the audit of the financial statements. For example, the audit report on the financial statements may make reference to the audit of a significant equity investment performed by another independent auditor, but the report on internal control over financial reporting might not make a similar reference because management's evaluation of internal control over financial reporting ordinarily would not extend to controls at the equity method investee.[23/]

185. When the auditor decides to make reference to the report of the other auditor as a basis, in part, for his or her opinions, the auditor should refer to the

[23/] See Appendix B, paragraph B15, for further discussion of the evaluation of the controls over financial reporting for an equity method investment.

report of the other auditor when describing the scope of the audit and when expressing the opinions.

186. *Subsequent Events*. Changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting might occur subsequent to the date as of which internal control over financial reporting is being audited but before the date of the auditor's report. The auditor should inquire of management whether there were any such changes or factors. As described in paragraph 142, the auditor should obtain written representations from management relating to such matters. Additionally, to obtain information about whether changes have occurred that might affect the effectiveness of the company's internal control over financial reporting and, therefore, the auditor's report, the auditor should inquire about and examine, for this subsequent period, the following:

- Relevant internal audit reports (or similar functions, such as loan review in a financial institution) issued during the subsequent period;

- Independent auditor reports (if other than the auditor's) of significant deficiencies or material weaknesses;

- Regulatory agency reports on the company's internal control over financial reporting; and

- Information about the effectiveness of the company's internal control over financial reporting obtained through other engagements.

187. The auditor could inquire about and examine other documents for the subsequent period. Paragraphs .01 through .09 of AU sec. 560, *Subsequent Events*, provides direction on subsequent events for a financial statement audit that also may be helpful to the auditor performing an audit of internal control over financial reporting.

188. If the auditor obtains knowledge about subsequent events that materially and adversely affect the effectiveness of the company's internal control over financial reporting as of the date specified in the assessment, the auditor should issue an adverse opinion on the effectiveness of internal control over financial reporting (and issue an adverse opinion on management's assessment of internal control over financial reporting if management's report does not appropriately assess the affect of the subsequent event). If the auditor is unable to determine the effect of the subsequent event on the effectiveness of the company's internal control over financial reporting, the auditor should disclaim opinions. As described in paragraph 190, the auditor should disclaim an opinion

on management's disclosures about corrective actions taken by the company after the date of management's assessment, if any.

189. The auditor may obtain knowledge about subsequent events with respect to conditions that did not exist at the date specified in the assessment but arose subsequent to that date. If a subsequent event of this type has a material effect on the company, the auditor should include in his or her report an explanatory paragraph describing the event and its effects or directing the reader's attention to the event and its effects as disclosed in management's report. Management's consideration of such events to be disclosed in its report should be limited to a change that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

190. *Management's Report Containing Additional Information*. Management's report on internal control over financial reporting may contain information in addition to management's assessment of the effectiveness of its internal control over financial reporting. Such information might include, for example:

- Disclosures about corrective actions taken by the company after the date of management's assessment;
- The company's plans to implement new controls; and
- A statement that management believes the cost of correcting a material weakness would exceed the benefits to be derived from implementing new controls.

191. If management's assessment includes such additional information, the auditor should disclaim an opinion on the information. For example, the auditor should use the following language as the last paragraph of the report to disclaim an opinion on management's cost-benefit statement:

> We do not express an opinion or any other form of assurance on management's statement referring to the costs and related benefits of implementing new controls.

192. If the auditor believes that management's additional information contains a material misstatement of fact, he or she should discuss the matter with management. If the auditor concludes that there is a valid basis for concern, he or she should propose that management consult with some other party whose advice might be useful, such as the company's legal counsel. If, after discussing the matter with management and those management has consulted, the auditor concludes that a material misstatement of fact remains, the auditor should notify management and the audit committee, in writing, of the auditor's views concerning the information. The auditor also should consider consulting the

auditor's legal counsel about further actions to be taken, including the auditor's responsibility under Section 10A of the Securities Exchange Act of 1934.[24/]

> Note: If management makes the types of disclosures described in paragraph 190 outside its report on internal control over financial reporting and includes them elsewhere within its annual report on the company's financial statements, the auditor would not need to disclaim an opinion, as described in paragraph 191. However, in that situation, the auditor's responsibilities are the same as those described in paragraph 192 if the auditor believes that the additional information contains a material misstatement of fact.

193. *Effect of Auditor's Adverse Opinion on Internal Control Over Financial Reporting on the Opinion on Financial Statements*. In some cases, the auditor's report on internal control over financial reporting might describe a material weakness that resulted in an adverse opinion on the effectiveness of internal control over financial reporting while the audit report on the financial statements remains unqualified. Consequently, during the audit of the financial statements, the auditor did not rely on that control. However, he or she performed additional substantive procedures to determine whether there was a material misstatement in the account related to the control. If, as a result of these procedures, the auditor determines that there was not a material misstatement in the account, he or she would be able to express an unqualified opinion on the financial statements.

194. When the auditor's opinion on the financial statements is unaffected by the adverse opinion on the effectiveness of internal control over financial reporting, the report on internal control over financial reporting (or the combined report, if a combined report is issued) should include the following or similar language in the paragraph that describes the material weakness:

> This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 20X3 financial statements, and this report does not affect our report dated [*date of report*] on those financial statements. [*Revise this wording appropriately for use in a combined report*.]

195. Such disclosure is important to ensure that users of the auditor's report on the financial statements understand why the auditor issued an unqualified opinion on those statements.

196. Disclosure is also important when the auditor's opinion on the financial statements is affected by the adverse opinion on the effectiveness of internal control over financial reporting. In that circumstance, the report on internal

[24/] See Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. 78j-1.

control over financial reporting (or the combined report, if a combined report is issued) should include the following or similar language in the paragraph that describes the material weakness:

> This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 20X3 financial statements.

197. *Subsequent Discovery of Information Existing at the Date of the Auditor's Report on Internal Control Over Financial Reporting*. After the issuance of the report on internal control over financial reporting, the auditor may become aware of conditions that existed at the report date that might have affected the auditor's opinions had he or she been aware of them. The auditor's evaluation of such subsequent information is similar to the auditor's evaluation of information discovered subsequent to the date of the report on an audit of financial statements, as described in AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*. That standard requires the auditor to determine whether the information is reliable and whether the facts existed at the date of his or her report. If so, the auditor should determine (1) whether the facts would have changed the report if he or she had been aware of them and (2) whether there are persons currently relying on or likely to rely on the auditor's report. For instance, if previously issued financial statements and the auditor's report have been recalled and reissued to reflect the correction of a misstatement, the auditor should presume that his or her report on the company's internal control over financial reporting as of same specified date also should be recalled and reissued to reflect the material weakness that existed at that date. Based on these considerations, paragraph .06 of AU sec. 561 provides detailed requirements for the auditor.

198. *Filings Under Federal Securities Statutes*. AU sec. 711, *Filings Under Federal Securities Statutes*, describes the auditor's responsibilities when an auditor's report is included in registration statements, proxy statements, or periodic reports filed under the federal securities statutes. The auditor should also apply AU sec. 711 with respect to the auditor's report on management's assessment of the effectiveness of internal control over financial reporting included in such filings. In addition, the direction in paragraph .10 of AU sec. 711 to inquire of and obtain written representations from officers and other executives responsible for financial and accounting matters about whether any events have occurred that have a material effect on the audited financial statements should be extended to matters that could have a material effect on management's assessment of internal control over financial reporting.

199. When the auditor has fulfilled these responsibilities and intends to consent to the inclusion of his or her report on management's assessment of the effectiveness of internal control over financial reporting in the securities filing, the auditor's consent should clearly indicate that both the audit report on financial

statements and the audit report on management's assessment of the effectiveness of internal control over financial reporting (or both opinions if a combined report is issued) are included in his or her consent.

Auditor's Responsibilities for Evaluating Management's Certification Disclosures About Internal Control Over Financial Reporting

Required Management Certifications

200. Section 302 of the Act, and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies,[25/] requires a company's management, with the participation of the principal executive and financial officers (the certifying officers), to make the following quarterly and annual certifications with respect to the company's internal control over financial reporting:

- A statement that the certifying officers are responsible for establishing and maintaining internal control over financial reporting;

- A statement that the certifying officers have designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under their supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles; and

- A statement that the report discloses any changes in the company's internal control over financial reporting that occurred during the most recent fiscal quarter (the company's fourth fiscal quarter in the case of an annual report) that have materially affected, or are reasonably likely to materially affect, the company's internal control over financial reporting.

201. When the reason for a change in internal control over financial reporting is the correction of a material weakness, management has a responsibility to determine and the auditor should evaluate whether the reason for the change and the circumstances surrounding that change are material information necessary to make the disclosure about the change not misleading.[26/]

25/ See 17 C.F.R., 240.13a-14a or 15d-14a, whichever applies.

26/ See Securities Exchange Act Rule 12b-20, 17 C.F.R. 240.12b-20.

Auditor Evaluation Responsibilities

202. The auditor's responsibility as it relates to management's quarterly certifications on internal control over financial reporting is different from the auditor's responsibility as it relates to management's annual assessment of internal control over financial reporting. The auditor should perform limited procedures quarterly to provide a basis for determining whether he or she has become aware of any material modifications that, in the auditor's judgment, should be made to the disclosures about changes in internal control over financial reporting in order for the certifications to be accurate and to comply with the requirements of Section 302 of the Act.

203. To fulfill this responsibility, the auditor should perform, on a quarterly basis, the following procedures:

- Inquire of management about significant changes in the design or operation of internal control over financial reporting as it relates to the preparation of annual as well as interim financial information that could have occurred subsequent to the preceding annual audit or prior review of interim financial information;
- Evaluate the implications of misstatements identified by the auditor as part of the auditor's required review of interim financial information (See AU sec. 722, *Interim Financial Information*) as it relates to effective internal control over financial reporting; and
- Determine, through a combination of observation and inquiry, whether any change in internal control over financial reporting has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

Note: Foreign private issuers filing Forms 20-F and 40-F are not subject to quarterly reporting requirements, therefore, the auditor's responsibilities would extend only to the certifications in the annual report of these companies.

204. When matters come to auditor's attention that lead him or her to believe that modification to the disclosures about changes in internal control over financial reporting is necessary for the certifications to be accurate and to comply with the requirements of Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies,[27/] the auditor should

[27/] See 17 C.F.R. 240.13a-14(a) or 17 C.F.R. 240.15d-14(a), whichever applies.

communicate the matter(s) to the appropriate level of management as soon as practicable.

205. If, in the auditor's judgment, management does not respond appropriately to the auditor's communication within a reasonable period of time, the auditor should inform the audit committee. If, in the auditor's judgment, the audit committee does not respond appropriately to the auditor's communication within a reasonable period of time, the auditor should evaluate whether to resign from the engagement. The auditor should evaluate whether to consult with his or her attorney when making these evaluations. In these circumstances, the auditor also has responsibilities under AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934.[28/] The auditor's responsibilities for evaluating the disclosures about changes in internal control over financial reporting do not diminish in any way management's responsibility for ensuring that its certifications comply with the requirements of Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies.[29/]

206. If matters come to the auditor's attention as a result of the audit of internal control over financial reporting that lead him or her to believe that modifications to the disclosures about changes in internal control over financial reporting (addressing changes in internal control over financial reporting occurring during the fourth quarter) are necessary for the annual certifications to be accurate and to comply with the requirements of Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies,[30/] the auditor should follow the same communication responsibilities as described in paragraphs 204 and 205. However, if management and the audit committee do not respond appropriately, in addition to the responsibilities described in the preceding two paragraphs, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons the auditor believes management's disclosures should be modified.

Required Communications in An Audit of Internal Control Over Financial Reporting

207. The auditor must communicate in writing to management and the audit committee all significant deficiencies and material weaknesses identified during the audit. The written communication should be made prior to the issuance of

28/ See 15 U.S.C. 78j-1.

29/ See 17 C.F.R. 240.13a-14(a) or 17 C.F.R. 240.15d-14(a), whichever applies.

30/ See 17 C.F.R. 240.13a-14(a) or 17 C.F.R. 240.15d-14(a), whichever applies.

the auditor's report on internal control over financial reporting. The auditor's communication should distinguish clearly between those matters considered to be significant deficiencies and those considered to be material weaknesses, as defined in paragraphs 9 and 10, respectively.

208. If a significant deficiency or material weakness exists because the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that specific significant deficiency or material weakness in writing to the board of directors.

209. In addition, the auditor should communicate to management, in writing, all deficiencies in internal control over financial reporting (that is, those deficiencies in internal control over financial reporting that are of a lesser magnitude than significant deficiencies) identified during the audit and inform the audit committee when such a communication has been made. When making this communication, it is not necessary for the auditor to repeat information about such deficiencies that have been included in previously issued written communications, whether those communications were made by the auditor, internal auditors, or others within the organization. Furthermore, the auditor is not required to perform procedures sufficient to identify all control deficiencies; rather, the auditor should communicate deficiencies in internal control over financial reporting of which he or she is aware.

> Note: As part of his or her evaluation of the effectiveness of internal control over financial reporting, the auditor should determine whether control deficiencies identified by internal auditors and others within the company, for example, through ongoing monitoring activities and the annual assessment of internal control over financial reporting, are reported to appropriate levels of management in a timely manner. The lack of an internal process to report deficiencies in internal control to management on a timely basis represents a control deficiency that the auditor should evaluate as to severity.

210. These written communications should state that the communication is intended solely for the information and use of the board of directors, audit committee, management, and others within the organization. When there are requirements established by governmental authorities to furnish such reports, specific reference to such regulatory agencies may be made.

211. These written communications also should include the definitions of control deficiencies, significant deficiencies, and material weaknesses and should clearly distinguish to which category the deficiencies being communicated relate.

212. Because of the potential for misinterpretation of the limited degree of assurance associated with the auditor issuing a written report representing that no significant deficiencies were noted during an audit of internal control over financial reporting, the auditor should not issue such representations.

213. When auditing internal control over financial reporting, the auditor may become aware of fraud or possible illegal acts. If the matter involves fraud, it must be brought to the attention of the appropriate level of management. If the fraud involves senior management, the auditor must communicate the matter directly to the audit committee as described in AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*. If the matter involves possible illegal acts, the auditor must assure himself or herself that the audit committee is adequately informed, unless the matter is clearly inconsequential, in accordance with AU sec. 317, *Illegal Acts by Clients*. The auditor also must determine his or her responsibilities under Section 10A of the Securities Exchange Act of 1934.[31/]

214. When timely communication is important, the auditor should communicate the preceding matters during the course of the audit rather than at the end of the engagement. The decision about whether to issue an interim communication should be determined based on the relative significance of the matters noted and the urgency of corrective follow-up action required.

Effective Date

215. Companies considered *accelerated filers* under Securities Exchange Act Rule 12b-2[32/] are required to comply with the internal control reporting and disclosure requirements of Section 404 of the Act *for fiscal years ending on or after November 15, 2004*. (Other companies have until fiscal years ending on or after July 15, 2005, to comply with these internal control reporting and disclosure requirements.) Accordingly, independent auditors engaged to audit the financial statements of accelerated filers for fiscal years ending on or after November 15, 2004, also are required to audit and report on the company's internal control over financial reporting as of the end of such fiscal year. This standard is required to be complied with for such engagements, except as it relates to the auditor's responsibilities for evaluating management's certification disclosures about internal control over financial reporting. The auditor's responsibilities for evaluating management's certification disclosures about internal control over financial reporting described in paragraphs 202 through 206 take effect beginning with the first quarter after the auditor's first audit report on the company's internal control over financial reporting.

216. Early compliance with this standard is permitted.

31/ See 15 U.S.C. 78j-1.

32/ See 17 C.F.R. 240.12b-2.

APPENDIX A

Illustrative Reports on Internal Control Over Financial Reporting

A1. Paragraphs 167 through 199 of this standard provide direction on the auditor's report on management's assessment of internal control over financial reporting. The following examples illustrate how to apply that direction in several different situations.

ILLUSTRATIVE REPORT
PAGE

Example A-1

ILLUSTRATIVE REPORT EXPRESSING AN UNQUALIFIED OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING AND AN UNQUALIFIED OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING (SEPARATE REPORT)[33/]

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We have audited management's assessment, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

[*Scope paragraph*]

33/ If the auditor issues separate reports on the audit of internal control over financial reporting and the audit of the financial statements, both reports should include a statement that the audit was conducted in accordance with standards of the Public Company Accounting Oversight Board (United States).

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, management's assessment that W Company maintained effective internal control over financial reporting as of December 31, 20X3, is fairly stated, in all material respects, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. Also in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated*

Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."].

[*Explanatory paragraph*]

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting*] expressed [*include nature of opinion*].

[*Signature*]

[*City and State or Country*]

[*Date*]

Example A-2

ILLUSTRATIVE REPORT EXPRESSING AN UNQUALIFIED OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING AND AN ADVERSE OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING BECAUSE OF THE EXISTENCE OF A MATERIAL WEAKNESS

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We have audited management's assessment, included in the accompanying [*title of management's report*], that W Company did not maintain effective internal control over financial reporting as of December 31, 20X3, because of the effect of [*material weakness identified in management's assessment*], based on [*Identify criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

[*Scope paragraph*]

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Explanatory paragraph*]

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weakness has been identified and included in management's assessment. [*Include a description of the material weakness and its effect on the achievement of the objectives of the control criteria.*] This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 20X3 financial statements, and this report does not affect our report dated [*date of report, which should be the same as the date of this report on internal control*] on those financial statements.[34/]

[*Opinion paragraph*]

In our opinion, management's assessment that W Company did not maintain effective internal control over financial reporting as of December 31, 20X3, is fairly stated, in all material respects, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. Also, in our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, W Company has not maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Signature*]

[*City and State or Country*]

[*Date*]

Example A-3

ILLUSTRATIVE REPORT EXPRESSING A QUALIFIED OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING AND A QUALIFIED OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING BECAUSE OF A LIMITATION ON THE SCOPE OF THE AUDIT

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We have audited management's assessment, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the*

[34/] Modify this sentence when the auditor's opinion on the financial statements is affected by the adverse opinion on the effectiveness of internal control over financial reporting, as described in paragraph 196.

Treadway Commission (COSO)."]. W Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

[*Scope paragraph*]

Except as described below, we conducted our audit in accordance the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

[*Explanatory paragraph that describes scope limitation*]

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weakness has been identified and included in management's assessment.[35/] Prior to December 20, 20X3, W Company had an inadequate system for recording cash receipts, which could have prevented the Company from recording cash receipts on accounts receivable completely and properly. Therefore, cash received could have been diverted for unauthorized use, lost, or otherwise not properly recorded to accounts receivable. We believe this condition was a material weakness in the design or operation of the internal control of W Company in effect prior to December 20, 20X3. Although the Company implemented a new cash receipts system on December 20, 20X3, the system has not been in operation for a sufficient period of time to enable us to obtain sufficient evidence about its operating effectiveness.

[*Definition paragraph*]

[35/] If the auditor has identified a material weakness that is not included in management's assessment, add the following wording to the report: "In addition, we have identified the following material weakness that has not been identified as a material weakness in management's assessment."

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, except for the effect of matters we might have discovered had we been able to examine evidence about the effectiveness of the new cash receipts system, management's assessment that W Company maintained effective internal control over financial reporting as of December 31, 20X3, is fairly stated, in all material respects, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. Also, in our opinion, except for the effect of matters we might have discovered had we been able to examine evidence about the effectiveness of the new cash receipts system, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Explanatory paragraph*]

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as* *the date of the report on the effectiveness of internal control over financial reporting*] expressed [*include nature of opinion*].

[*Signature*]

[*City and State or Country*]

[*Date*]

Example A-4

ILLUSTRATIVE REPORT DISCLAIMING AN OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING AND DISCLAIMING AN OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING BECAUSE OF A LIMITATION ON THE SCOPE OF THE AUDIT

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]
We were engaged to audit management's assessment included in the accompanying [*title of management's report*] that W Company maintained effective internal control over financial reporting as of December 31, 20X3 based on [*Identify control criteria,* f*or example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting.

[*Omit scope paragraph*]

[*Explanatory paragraph that describes scope limitation*][36/]

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over

36/ If, through the limited procedures performed, the auditor concludes that a material weakness exists, the auditor should add the definition of material weakness (as provided in paragraph 10) to the explanatory paragraph. In addition, the auditor should include a description of the material weakness and its effect on the achievement of the objectives of the control criteria.

financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

Since management [*describe scope restrictions*] and we were unable to apply other procedures to satisfy ourselves as to the effectiveness of the company's internal control over financial reporting, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion either on management's assessment or on the effectiveness of the company's internal control over financial reporting.

[*Explanatory paragraph*]

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting*] expressed [*include nature of opinion*].

[*Signature*]

[*City and State or Country*]

[*Date*]

Example A-5

ILLUSTRATIVE REPORT EXPRESSING AN UNQUALIFIED OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING THAT REFERS TO THE REPORT

OF OTHER AUDITORS AS A BASIS, IN PART, FOR THE AUDITOR'S OPINION AND AN UNQUALIFIED OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We have audited management's assessment, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit. We did not examine the effectiveness of internal control over financial reporting of B Company, a wholly owned subsidiary, whose financial statements reflect total assets and revenues constituting 20 and 30 percent, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 20X3. The effectiveness of B Company's internal control over financial reporting was audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the effectiveness of B Company's internal control over financial reporting, is based solely on the report of the other auditors.

[*Scope paragraph*]

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit and the report of the other auditors provide a reasonable basis for our opinion.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, based on our audit and the report of the other auditors, management's assessment that W Company maintained effective internal control over financial reporting as of December 31, 20X3, is fairly stated, in all material respects, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. Also, in our opinion, based on our audit and the report of the other auditors, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Explanatory paragraph*]

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting*] expressed [*include nature of opinion*].

[*Signature*]

[*City and State or Country*]

[*Date*]

Example A-6

ILLUSTRATIVE REPORT EXPRESSING AN ADVERSE OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING AND AN ADVERSE OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING BECAUSE OF THE EXISTENCE OF A MATERIAL WEAKNESS

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We have audited management's assessment, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

[*Scope paragraph*]

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Explanatory paragraph*]

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. We have identified the following material weakness that has not been identified as a material weakness in management's assessment [*Include a description of the material weakness and its effect on the achievement of the objectives of the control criteria.*] This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 20X3 financial statements, and this report does not affect our report dated [*date of report, which should be the same as the date of this report on internal control*] on those financial statements.[37/]

[*Opinion paragraph*]

In our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, management's assessment that W Company maintained effective internal control over financial reporting as of December 31, 20X3, is not fairly stated, in all material respects, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. Also, in our opinion, because of the effect of the material weakness described above on the

[37/] Modify this sentence when the auditor's opinion on the financial statements is affected by the adverse opinion on the effectiveness of internal control over financial reporting.

achievement of the objectives of the control criteria, W Company has not maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Signature*]

[*City and State or Country*]

[*Date*]

Example A-7

ILLUSTRATIVE COMBINED REPORT EXPRESSING AN UNQUALIFIED OPINION ON FINANCIAL STATEMENTS, AN UNQUALIFIED OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING AND AN UNQUALIFIED OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We have audited the accompanying balance sheets of W Company as of December 31, 20X3 and 20X2, and the related statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 20X3. We also have audited management's assessment, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these financial statements, an opinion on management's assessment, and an opinion on the effectiveness of the company's internal control over financial reporting based on our audits.

[*Scope paragraph*]

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of W Company as of December 31, 20X3 and 20X2, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 20X3 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, management's assessment that W Company maintained effective internal control over financial reporting as of December 31, 20X3, is fairly stated, in all material respects, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. Furthermore, in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Signature*]

[*City and State or Country*]

[Date]

APPENDIX B

Additional Performance Requirements and Directions; Extent-of-Testing Examples

Tests to be Performed When a Company Has Multiple Locations or Business Units

B1. To determine the locations or business units for performing audit procedures, the auditor should evaluate their relative financial significance and the risk of material misstatement arising from them. In making this evaluation, the auditor should identify the locations or business units that are individually important, evaluate their documentation of controls, and test controls over significant accounts and disclosures. For locations or business units that contain specific risks that, by themselves, could create a material misstatement, the auditor should evaluate their documentation of controls and test controls over the specific risks.

B2. The auditor should determine the other locations or business units that, when aggregated, represent a group with a level of financial significance that could create a material misstatement in the financial statements. For that group, the auditor should determine whether there are company-level controls in place. If so, the auditor should evaluate the documentation and test such company-level controls. If not, the auditor should perform tests of controls at some of the locations or business units.

B3. No further work is necessary on the remaining locations or businesses, provided that they are not able to create, either individually or in the aggregate, a material misstatement in the financial statements.

Locations or Business Units That Are Financially Significant

B4. Because of the importance of financially significant locations or business units, the auditor should evaluate management's documentation of and perform tests of controls over all relevant assertions related to significant accounts and disclosures at each financially significant location or business unit, as discussed in paragraphs 83 through 105. Generally, a relatively small number of locations or business units will encompass a large portion of a company's operations and financial position, making them financially significant.

B5. In determining the nature, timing, and extent of testing at the individual locations or business units, the auditor should evaluate each entity's involvement, if any, with a central processing or shared service environment.

Locations or Business Units That Involve Specific Risks

B6. Although a location or business unit might not be individually financially significant, it might present specific risks that, by themselves, could create a material misstatement in the company's financial statements. The auditor should test the controls over the specific risks that could create a material misstatement in the company's financial statements. The auditor need not test controls over all relevant assertions related to all significant accounts at these locations or business units. For example, a business unit responsible for foreign exchange trading could expose the company to the risk of material misstatement, even though the relative financial significance of such transactions is low.

Locations or Business Units That Are Significant Only When Aggregated with Other Locations and Business Units

B7. In determining the nature, timing, and extent of testing, the auditor should determine whether management has documented and placed in operation company-level controls (See paragraph 53) over individually unimportant locations and business units that, when aggregated with other locations or business units, might have a high level of financial significance. A high level of financial significance could create a greater than remote risk of material misstatement of the financial statements.

B8. For the purposes of this evaluation, company-level controls are controls management has in place to provide assurance that appropriate controls exist throughout the organization, including at individual locations or business units.

B9. The auditor should perform tests of company-level controls to determine whether such controls are operating effectively. The auditor might conclude that he or she cannot evaluate the operating effectiveness of such controls without visiting some or all of the locations or business units.

B10. If management does not have company-level controls operating at these locations and business units, the auditor should determine the nature, timing, and extent of procedures to be performed at each location, business unit, or combination of locations and business units. When determining the locations or business units to visit and the controls to test, the auditor should evaluate the following factors:

- The relative financial significance of each location or business unit.
- The risk of material misstatement arising from each location or business unit.
- The similarity of business operations and internal control over financial reporting at the various locations or business units.
- The degree of centralization of processes and financial reporting applications.
- The effectiveness of the control environment, particularly management's direct control over the exercise of authority delegated to others and its ability to effectively supervise activities at the various locations or business units. An ineffective control environment over the locations or business units might constitute a material weakness.
- The nature and amount of transactions executed and related assets at the various locations or business units.
- The potential for material unrecognized obligations to exist at a location or business unit and the degree to which the location or business unit could create an obligation on the part of the company.
- Management's risk assessment process and analysis for excluding a location or business unit from its assessment of internal control over financial reporting.

B11. Testing company-level controls is not a substitute for the auditor's testing of controls over a large portion of the company's operations or financial position. If the auditor cannot test a large portion of the company's operations and financial position by selecting a relatively small number of locations or business units, he or she should expand the number of locations or business units selected to evaluate internal control over financial reporting.

Note: The evaluation of whether controls over a large portion of the company's operations or financial position have been tested should be made at the overall level, not at the individual significant account level.

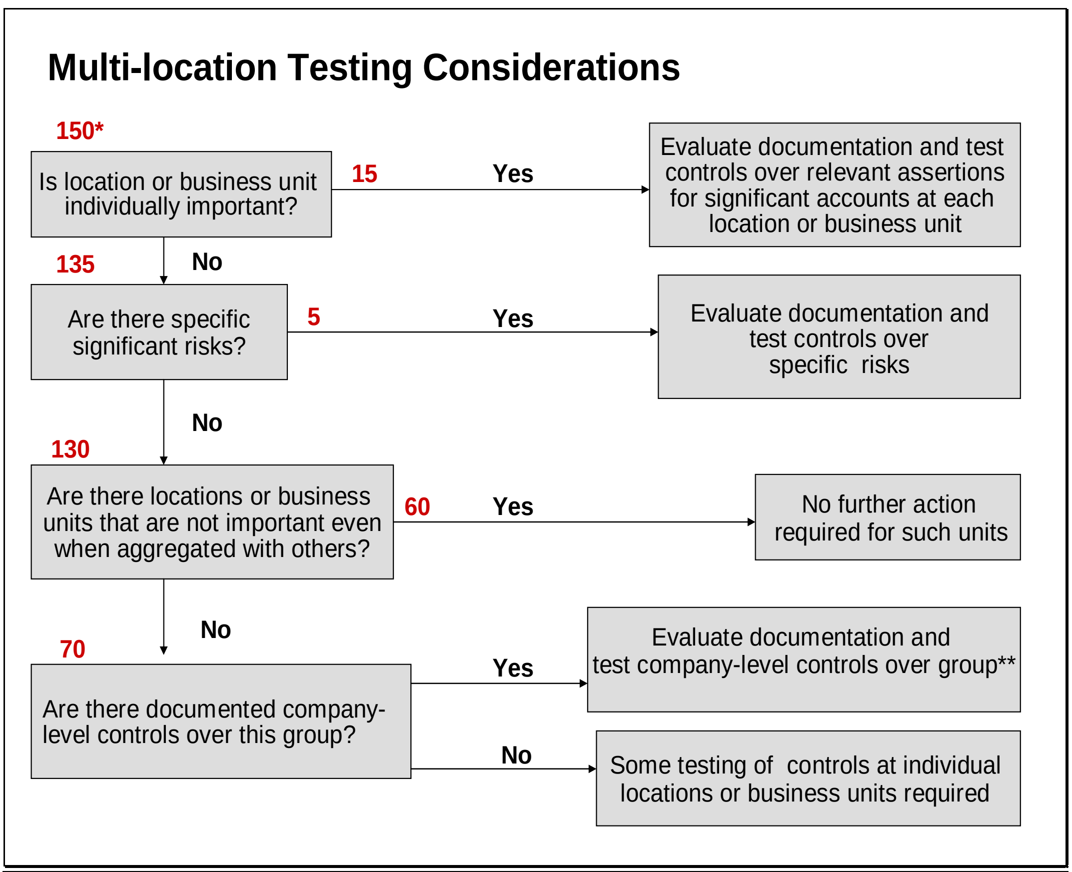
Locations and Business Units That Do Not Require Testing

B12. No testing is required for locations or business units that individually, and when aggregated with others, could not result in a material misstatement to the financial statements.

Multi-Location Testing Considerations Flowchart

B13. Illustration B-1 depicts how to apply the directions in this section to a hypothetical company with 150 locations or business units, along with the auditor's testing considerations for those locations or business units.

Illustration B-1



* Numbers represent number of locations affected.
** See paragraph B7.

Special Situations

B14. The scope of the evaluation of the company's internal control over financial reporting should include entities that are acquired on or before the date of management's assessment and operations that are accounted for as discontinued operations on the date of management's assessment. The auditor should consider this multiple locations discussion in determining whether it will be necessary to test controls at these entities or operations.

B15. For equity method investments, the evaluation of the company's internal control over financial reporting should include controls over the reporting in accordance with generally accepted accounting principles, in the company's financial statements, of the company's portion of the investees' income or loss, the investment balance, adjustments to the income or loss and investment balance, and related disclosures. The evaluation ordinarily would not extend to controls at the equity method investee.

B16. In situations in which the SEC allows management to limit its assessment of internal control over financial reporting by excluding certain entities, the auditor may limit the audit in the same manner and report without reference to the limitation in scope. However, the auditor should evaluate the reasonableness of management's conclusion that the situation meets the criteria of the SEC's allowed exclusion and the appropriateness of any required disclosure related to such a limitation. If the auditor believes that management's disclosure about the limitation requires modification, the auditor should follow the same communication responsibilities as described in paragraphs 204 and 205. If management and the audit committee do not respond appropriately, in addition to fulfilling those responsibilities, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons why the auditor believes management's disclosure should be modified.

B17. For example, for entities that are consolidated or proportionately consolidated, the evaluation of the company's internal control over financial reporting should include controls over significant accounts and processes that exist at the consolidated or proportionately consolidated entity. In some instances, however, such as for some variable interest entities as defined in Financial Accounting Standards Board Interpretation No. 46, *Consolidation of Variable Interest Entities,* management might not be able to obtain the information necessary to make an assessment because it does not have the ability to control the entity. If management is allowed to limit its assessment by excluding such entities,[38/] the auditor may limit the audit in the same manner and

[38/] It is our understanding that the SEC Staff may conclude that management can limit the scope of its assessment if it does not have the authority to affect, and therefore cannot assess, the controls in place over certain amounts. This would relate to entities that are consolidated or proportionately consolidated when the issuer does not have sufficient control over the entity to assess and affect controls. If management's report on its assessment of the effectiveness of internal control over financial reporting is limited in that manner, the SEC staff may permit the company to disclose this fact as well as information about the magnitude of the amounts included in the financial statements report without reference to the limitation in scope. In this case, the evaluation of the company's internal control over financial reporting should include evaluation of controls over the reporting in accordance with generally accepted accounting principles, in the company's financial statements, of the company's portion of the entity's income or loss, the investment balance, adjustments to the income or loss and investment balances, and related disclosures. However, the auditor should evaluate the reasonableness of management's conclusion that it does not have the ability to obtain the necessary information as well as the appropriateness of any required disclosure related to such a limitation.

Use of Service Organizations

B18. AU sec. 324, *Service Organizations,* applies to the audit of financial statements of a company that obtains services from another organization that are part of its information system. The auditor may apply the relevant concepts described in AU sec. 324 to the audit of internal control over financial reporting. Further, although AU sec. 324 was designed to address auditor-to-auditor communications as part of the audit of financial statements, it also is appropriate for management to apply the relevant concepts described in that standard to its assessment of internal control over financial reporting.

B19. Paragraph .03 of AU sec. 324 describes the situation in which a service organization's services are part of a company's information system. If the service organization's services are part of a company's information system, as described therein, then they are part of the information and communication component of the company's internal control over financial reporting. When the service organization's services are part of the company's internal control over financial reporting, management should consider the activities of the service organization in making its assessment of internal control over financial reporting, and the auditor should consider the activities of the service organization in determining the evidence required to support his or her opinion.

> Note: The use of a service organization does not reduce management's responsibility to maintain effective internal control over financial reporting.

B20. Paragraphs .07 through .16 in AU sec. 324 describe the procedures that management and the auditor should perform with respect to the activities performed by the service organization. The procedures include:

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from entities whose controls cannot be assessed. This disclosure would be required in each filing, but outside of management's report on its assessment of the effectiveness of internal control over financial reporting.

a. Obtaining an understanding of the controls at the service organization that are relevant to the entity's internal control and the controls at the user organization over the activities of the service organization, and

b. Obtaining evidence that the controls that are relevant to management's assessment and the auditor's opinion are operating effectively.

B21. Evidence that the controls that are relevant to management's assessment and the auditor's opinion are operating effectively may be obtained by following the procedures described in paragraph .12 of AU sec. 324. These procedures include:

a. Performing tests of the user organization's controls over the activities of the service organization (for example, testing the user organization's independent reperformance of selected items processed by the service organization or testing the user organization's reconciliation of output reports with source documents).

b. Performing tests of controls at the service organization.

c. Obtaining a service auditor's report on controls placed in operation and tests of operating effectiveness, or a report on the application of agreed-upon procedures that describes relevant tests of controls.

Note: The service auditor's report referred to above means a report with the service auditor's opinion on the service organization's description of the design of its controls, the tests of controls, and results of those tests performed by the service auditor, and the service auditor's opinion on whether the controls tested were operating effectively during the specified period (in other words, "reports on controls placed in operation and tests of operating effectiveness" described in paragraph .24b of AU sec. 324). A service auditor's report that does not include tests of controls, results of the tests, and the service auditor's opinion on operating effectiveness (in other words, "reports on controls placed in operation" described in paragraph .24a of AU sec. 324) does not provide evidence of operating effectiveness. Furthermore, if the evidence regarding operating effectiveness of controls comes from an agreed-upon procedures report rather than a service auditor's report issued pursuant to AU sec. 324, management and the auditor should evaluate whether the agreed-upon procedures report provides sufficient evidence in the same manner described in the following paragraph.

B22. If a service auditor's report on controls placed in operation and tests of operating effectiveness is available, management and the auditor may evaluate whether this report provides sufficient evidence to support the assessment and opinion, respectively. In evaluating whether such a service auditor's report provides sufficient evidence, management and the auditor should consider the following factors:

- The time period covered by the tests of controls and its relation to the date of management's assessment,

- The scope of the examination and applications covered, the controls tested, and the way in which tested controls relate to the company's controls,

- The results of those tests of controls and the service auditor's opinion on the operating effectiveness of the controls.

Note: These factors are similar to factors the auditor would consider in determining whether the report provides sufficient evidence to support the auditor's assessed level of control risk in an audit of the financial statements as described in paragraph .16 of AU sec. 324.

B23. If the service auditor's report on controls placed in operation and tests of operating effectiveness contains a qualification that the stated control objectives might be achieved only if the company applies controls contemplated in the design of the system by the service organization, the auditor should evaluate whether the company is applying the necessary procedures. For example, completeness of processing payroll transactions might depend on the company's validation that all payroll records sent to the service organization were processed by checking a control total.

B24. In determining whether the service auditor's report provides sufficient evidence to support management's assessment and the auditor's opinion, management and the auditor should make inquiries concerning the service auditor's reputation, competence, and independence. Appropriate sources of information concerning the professional reputation of the service auditor are discussed in paragraph .10a of AU sec. 543, *Part of Audit Performed by Other Independent Auditors.*

B25. When a significant period of time has elapsed between the time period covered by the tests of controls in the service auditor's report and the date of management's assessment, additional procedures should be performed. The auditor should inquire of management to determine whether management has identified any changes in the service organization's controls subsequent to the period covered by the service auditor's report (such as changes communicated to management from the service organization, changes in personnel at the service organization with whom management interacts, changes in reports or other data received from the service organization, changes in contracts or service level agreements with the service organization, or errors identified in the service organization's processing). If management has identified such changes, the auditor should determine whether management has performed procedures to evaluate the effect of such changes on the effectiveness of the company's internal control over financial reporting. The auditor also should consider whether the results of other procedures he or she performed indicate that there have been changes in the controls at the service organization that management has not identified.

B26. The auditor should determine whether to obtain additional evidence about the operating effectiveness of controls at the service organization based on the procedures performed by management or the auditor and the results of those procedures and on an evaluation of the following factors. As these factors increase in significance, the need for the auditor to obtain additional evidence increases.

- The elapsed time between the time period covered by the tests of controls in the service auditor's report and the date of management's assessment,
- The significance of the activities of the service organization,
- Whether there are errors that have been identified in the service organization's processing, and
- The nature and significance of any changes in the service organization's controls identified by management or the auditor.

B27. If the auditor concludes that additional evidence about the operating effectiveness of controls at the service organization is required, the auditor's additional procedures may include:

- Evaluating the procedures performed by management and the results of those procedures.
- Contacting the service organization, through the user organization, to obtain specific information.
- Requesting that a service auditor be engaged to perform procedures that will supply the necessary information.
- Visiting the service organization and performing such procedures.

B28. Based on the evidence obtained, management and the auditor should determine whether they have obtained sufficient evidence to obtain the reasonable assurance necessary for their assessment and opinion, respectively.

B29. The auditor should not refer to the service auditor's report when expressing an opinion on internal control over financial reporting.

Examples of Extent-of-Testing Decisions

B30. As discussed throughout this standard, determining the effectiveness of a company's internal control over financial reporting includes evaluating the design and operating effectiveness of controls over all relevant assertions related to all significant accounts and disclosures in the financial statements. Paragraphs 88 through 107 provide the auditor with directions about the nature, timing, and extent of testing of the design and operating effectiveness of internal control over financial reporting.

B31. Examples B-1 through B-4 illustrate how to apply this information in various situations. These examples are for illustrative purposes only.

Example B-1 – ***Daily Programmed Application Control and Daily Information Technology-Dependent Manual Control***

The auditor has determined that cash and accounts receivable are significant accounts to the audit of XYZ Company's internal control over financial reporting. Based on discussions with company personnel and review of company documentation, the auditor learned that the company had the following procedures in place to account for cash received in the lockbox:

a. The company receives a download of cash receipts from the banks.

b. The information technology system applies cash received in the lockbox to individual customer accounts.

c. Any cash received in the lockbox and not applied to a customer's account is listed on an exception report (Unapplied Cash Exception Report).

- Therefore, the application of cash to a customer's account is a programmed application control, while the review and follow-up of unapplied cash from the exception report is a manual control.

To determine whether misstatements in cash (existence assertion) and accounts receivable (existence, valuation, and completeness) would be prevented or detected on a timely basis, the auditor decided to test the controls provided by the system in the daily reconciliation of lock box receipts to customer accounts, as well as the control over reviewing and resolving unapplied cash in the Unapplied Cash Exception Report.

Nature, Timing, and Extent of Procedures. To test the programmed application control, the auditor:

- Identified, through discussion with company personnel, the software used to receive the download from the banks and to process the transactions and determined that the banks supply the download software.

  -- The company uses accounting software acquired from a third-party supplier. The software consists of a number of modules. The client modifies the software only for upgrades supplied by the supplier.

- Determined, through further discussion with company personnel, that the cash module operates the lockbox functionality and the posting of cash to the general ledger. The accounts receivable module posts the cash to individual customer accounts and produces the Unapplied Cash Exception Report, a standard report supplied with the package. The auditor agreed this information to the supplier's documentation.

- Identified, through discussions with company personnel and review of the supplier's documentation, the names, file sizes (in bytes), and locations of the executable files (programs) that operate the functionality under review. The auditor then identified the compilation dates of these programs and agreed them to the original installation date of the application.

- Identified the objectives of the programs to be tested. The auditor wanted to determine whether only appropriate cash items are posted to customers' accounts and matched to customer number, invoice number, amount, etc., and that there is a listing of inappropriate cash items (that is, any of the above items not matching) on the exception report.

In addition, the auditor had evaluated and tested general computer controls, including program changes (for example, confirmation that no unauthorized changes are undertaken) and logical access (for example, data file access to the file downloaded from the banks and user access to the cash and accounts receivable modules) and concluded that they were operating effectively.

To determine whether such programmed controls were operating effectively, the auditor performed a walkthrough in the month of July. The computer controls operate in a systematic manner, therefore, the auditor concluded that it was sufficient to perform a walkthrough for only the one item. During the walkthrough, the auditor performed and documented the following items:

a. Selected one customer and agreed the amount billed to the customer to the cash received in the lockbox.

b. Agreed the total of the lockbox report to the posting of cash receipts in the general ledger.

c. Agreed the total of the cash receipt download from the bank to the lockbox report and supporting documentation.

d. Selected one customer's remittance and agreed amount posted to the customer's account in the accounts receivable subsidiary ledger.

To test the detective control of review and follow up on the Daily Unapplied Cash Exception Report, the auditor:

a. Made inquiries of company personnel. To understand the procedures in place to ensure that all unapplied items are resolved, the time frame in which such resolution takes place, and whether unapplied items are handled properly within the system, the auditor discussed these matters with the employee responsible for reviewing and resolving the Daily Unapplied Cash Exception Reports. The auditor learned that, when items appear on the Daily-Unapplied Cash Exception Report, the employee must manually enter the correction into the system. The employee typically performs the resolution procedures the next business day. Items that typically appear on the Daily Unapplied Cash Exception Report relate to payments made by a customer without reference to an invoice number/purchase order number or to underpayments of an invoice due to quantity or pricing discrepancies.

b. Observed personnel performing the control**.** The auditor then observed the employee reviewing and resolving a Daily Unapplied Cash Exception Report. The day selected contained four exceptions – three related to payments made by a customer without an invoice number, and one related to an underpayment due to a pricing discrepancy.

- For the pricing discrepancy, the employee determined, through discussions with a sales person, that the customer had been billed an incorrect price; a price break that the sales person had granted to the customer was not reflected on the customer's invoice. The employee resolved the pricing discrepancy, determined which invoices were being paid, and entered a correction into the system to properly apply cash to the customer's account and reduce accounts receivable and sales accounts for the amount of the price break.

c. Reperformed the control. Finally, the auditor selected 25 Daily Unapplied Cash Exception Reports from the period January to September. For the reports selected, the auditor reperformed the follow-up procedures that the employee performed. For instance, the auditor inspected the documents and sources of information used in the follow-up and determined that the transaction was properly corrected in the system. The auditor also scanned other Daily Unapplied Cash Exception Reports to determine that the control was performed throughout the period of intended reliance.

Because the tests of controls were performed at an interim date, the auditor had to determine whether there were any significant changes in the controls from interim to year-end. Therefore, the auditor asked company personnel about the procedures in place at year-end. Such procedures had not changed from the interim period, therefore, the auditor observed that the controls were still in place by scanning Daily Unapplied Cash Exception Reports to determine the control was performed on a timely basis during the period from September to year-end.

Based on the auditor's procedures, the auditor concluded that the employee was clearing exceptions in a timely manner and that the control was operating effectively as of year-end.

Example B-2 – ***Monthly Manual Reconciliation***

The auditor determined that accounts receivable is a significant account to the audit of XYZ Company's internal control over financial reporting. Through discussions with company personnel and review of company documentation, the auditor learned that company personnel reconcile the accounts receivable subsidiary ledger to the general ledger on a monthly basis. To determine whether misstatements in accounts receivable (existence, valuation, and completeness) would be detected on a timely basis, the auditor decided to test the control provided by the monthly reconciliation process.

Nature, Timing, and Extent of Procedures. The auditor tested the company's reconciliation control by selecting a sample of reconciliations based upon the number of accounts, the dollar value of the accounts, and the volume of transactions affecting the account. Because the auditor considered all other receivable accounts immaterial, and because such accounts had only minimal transactions flowing through them, the auditor decided to test only the reconciliation for the trade accounts receivable account. The auditor elected to perform the tests of controls over the reconciliation process in conjunction with the auditor's substantive procedures over the accounts receivable confirmation procedures, which were performed in July.

To test the reconciliation process, the auditor:

a. Made inquiries of personnel performing the control. The auditor asked the employee performing the reconciliation a number of questions, including the following:

- What documentation describes the account reconciliation process?
- How long have you been performing the reconciliation work?
- What is the reconciliation process for resolving reconciling items?
- How often are the reconciliations formally reviewed and signed off?

- If significant issues or reconciliation problems are noticed, to whose attention do you bring them?

- On average, how many reconciling items are there?

- How are old reconciling items treated?

- If need be, how is the system corrected for reconciling items?

- What is the general nature of these reconciling items?

b. Observed the employee performing the control**.** The auditor observed the employee performing the reconciliation procedures. For nonrecurring reconciling items, the auditor observed whether each item included a clear explanation as to its nature, the action that had been taken to resolve it, and whether it had been resolved on a timely basis.

c. Reperformed the control**.** Finally, the auditor inspected the reconciliations and reperfomed the reconciliation procedures. For the May and July reconciliations, the auditor traced the reconciling amounts to the source documents on a test basis. The only reconciling item that appeared on these reconciliations was cash received in the lockbox the previous day that had not been applied yet to the customer's account. The auditor pursued the items in each month's reconciliation to determine that the reconciling item cleared the following business day. The auditor also scanned through the file of all reconciliations prepared during the year and noted that they had been performed on a timely basis. To determine that the company had not made significant changes in its reconciliation control procedures from interim to year-end, the auditor made inquiries of company personnel and determined that such procedures had not changed from interim to year-end. Therefore, the auditor verified that controls were still in place by scanning the monthly account reconciliations to determine that the control was performed on a timely basis during the interim to year-end period.

Based on the auditor's procedures, the auditor concluded that the reconciliation control was operating effectively as of year-end.

Example B-3 – ***Daily Manual Preventive Control***

The auditor determined that cash and accounts payable were significant accounts to the audit of the company's internal control over financial reporting. Through discussions with company personnel, the auditor learned that company personnel make a cash disbursement only after they have matched the vendor invoice to the receiver and purchase order. To determine whether misstatements in cash (existence) and accounts payable (existence, valuation, and completeness) would be prevented on a timely basis, the auditor tested the control over making a cash disbursement only after matching the invoice with the receiver and purchase.

Nature, Timing, and Extent of Procedures. On a haphazard basis, the auditor selected 25 disbursements from the cash disbursement registers from January through September. In this example, the auditor deemed a test of 25 cash disbursement transactions an appropriate sample size because the auditor was testing a manual control performed as part of the routine processing of cash disbursement transactions through the system. Furthermore, the auditor expected no errors based on the results of company-level tests performed earlier. [If, however, the auditor had encountered a control exception, the auditor would have attempted to identify the root cause of the exception and tested an additional number of items. If another control exception had been noted, the auditor would have decided that this control was not effective. As a result, the auditor would have decided to increase the extent of substantive procedures to be performed in connection with the financial statement audit of the cash and accounts payable accounts.]

a. After obtaining the related voucher package, the auditor examined the invoice to see if it included the signature or initials of the accounts payable clerk, evidencing the clerk's performance of the matching control. However, a signature on a voucher package to indicate signor approval does not necessarily mean that the person carefully reviewed it before signing. The voucher package may have been signed based on only a cursory review, or without any review.

b. The auditor decided that the quality of the evidence regarding the effective operation of the control evidenced by a signature or initials was not sufficiently persuasive to ensure that the control operated effectively during the test period. In order to obtain additional evidence, the auditor reperformed the matching control corresponding to the signature, which included examining the invoice to determine that (a) its items matched to the receiver and purchase order and (b) it was mathematically accurate.

Because the auditor performed the tests of controls at an interim date, the auditor updated the testing through the end of the year (initial tests are through September to December) by asking the accounts payable clerk whether the control was still in place and operating effectively. The auditor confirmed that understanding by performing a walkthrough of one transaction in December.

Based on the auditor's procedures, the auditor concluded that the control over making a cash disbursement only after matching the invoice with the receiver and purchase was operating effectively as of year-end.

Example B-4 – ***Programmed Prevent Control and Weekly Information Technology-Dependent Manual Detective Control***

The auditor determined that cash, accounts payable, and inventory were significant accounts to the audit of the company's internal control over financial reporting. Through discussions with company personnel, the auditor learned that the company's computer system performs a three-way match of the receiver, purchase order, and invoice. If there are any exceptions, the system produces a list of unmatched items that employees review and follow up on weekly.

In this case, the computer match is a programmed application control, and the review and follow-up of the unmatched items report is a detective control. To determine whether misstatements in cash (existence) and accounts payable/inventory (existence, valuation, and completeness) would be prevented or detected on a timely basis, the auditor decided to test the programmed application control of matching the receiver, purchase order, and invoice as well as the review and follow-up control over unmatched items.

Nature, Timing, and Extent of Procedures. To test the programmed application control, the auditor:

a. Identified, through discussion with company personnel, the software used to process receipts and purchase invoices. The software used was a third-party package consisting of a number of modules.

b. Determined, through further discussion with company personnel, that they do not modify the core functionality of the software, but sometimes make personalized changes to reports to meet the changing needs of the business. From previous experience with the company's information technology environment, the auditor believes that such changes are infrequent and that information technology process controls are well established.

c. Established, through further discussion, that the inventory module operated the receiving functionality, including the matching of receipts to open purchase orders. Purchase invoices were processed in the accounts payable module, which matched them to an approved purchase order against which a valid receipt has been made. That module also produced the Unmatched Items Report, a standard report supplied with the package to which the company has not made any modifications. That information was agreed to the supplier's documentation and to documentation within the information technology department.

d. Identified, through discussions with the client and review of the supplier's documentation, the names, file sizes (in bytes), and locations of the executable files (programs) that operate the functionality under review. The auditor then identified the compilation dates of the programs and agreed them to the original installation date of the application. The compilation date of the report code was agreed to documentation held within the information technology department relating to the last change made to that report (a change in formatting).

e. Identified the objectives of the programs to be tested. The auditor wanted to determine whether appropriate items are received (for example, match a valid purchase order), appropriate purchase invoices are posted (for example, match a valid receipt and purchase order, non-duplicate reference numbers) and unmatched items (for example, receipts, orders or invoices) are listed on the exception report. The auditor then reperformed all those variations in the packages on a test-of-one basis to determine that the programs operated as described.

In addition, the auditor had evaluated and tested general computer controls, including program changes (for example, confirmation that no unauthorized changes are undertaken to the functionality and that changes to reports are appropriately authorized, tested, and approved before being applied) and logical access (for example, user access to the inventory and accounts payable modules and access to the area on the system where report code is maintained), and concluded that they were operating effectively. (Since the computer is deemed to operate in a systematic manner, the auditor concluded that it was sufficient to perform a walkthrough for only the one item.)

To determine whether the programmed control was operating effectively, the auditor performed a walkthrough in the month of July. As a result of the walkthrough, the auditor performed and documented the following items:

a. Receiving cannot record the receipt of goods without matching the receipt to a purchase order on the system. The auditor tested that control by attempting to record the receipt of goods into the system without a purchase order. However, the system did not allow the auditor to do that. Rather, the system produced an error message stating that the goods could not be recorded as received without an active purchase order.

b. An invoice will not be paid unless the system can match the receipt and vendor invoice to an approved purchase order. The auditor tested that control by attempting to approve an invoice for payment in the system. The system did not allow the auditor to do that. Rather, it produced an error message indicating that invoices could not be paid without an active purchase order and receiver.

c. The system disallows the processing of invoices with identical vendor and identical invoice numbers. In addition, the system will not allow two invoices to be processed against the same purchase order unless the sum of the invoices is less than the amount approved on the purchase order.

The auditor tested that control by attempting to process duplicate invoices. However, the system produced an error message indicating that the invoice had already been processed.

d. The system compares the invoice amounts to the purchase order. If there are differences in quantity/extended price, and such differences fall outside a pre-approved tolerance, the system does not allow the invoice to be processed. The auditor tested that control by attempting to process an invoice that had quantity/price differences outside the tolerance level of 10 pieces, or $1,000. The system produced an error message indicating that the invoice could not be processed because of such differences.

e. The system processes payments only for vendors established in the vendor master file. The auditor tested that control by attempting to process an invoice for a vendor that was not established in the vendor master file. However, the system did not allow the payment to be processed.

f. The auditor tested user access to the vendor file and whether such users can make modifications to such file by attempting to access and make changes to the vendor tables. However, the system did not allow the auditor to perform that function and produced an error message stating that the user was not authorized to perform that function.

g. The auditor verified the completeness and accuracy of the Unmatched Items Report by verifying that one unmatched item was on the report and one matched item was not on the report.

Note: It is inadvisable for the auditor to have uncontrolled access to the company's systems in his or her attempts described above to record the receipt of goods without a purchase order, approve an invoice for payment, process duplicate invoices, etc. These procedures ordinarily are performed in the presence of appropriate company personnel so that they can be notified immediately of any breach to their systems.

To test the detect control of review and follow up on the Unmatched Items Report, the auditor performed the following procedures in the month of July for the period January to July:

a. Made inquiries of company personnel. To gain an understanding of the procedures in place to ensure that all unmatched items are followed-up properly and that corrections are made on a timely basis, the auditor made inquiries of the employee who follows up on the weekly-unmatched items reports. On a weekly basis, the control required the employee to review the Unmatched Items Report to determine why items appear on it. The employee's review includes proper follow-up on items, including determining whether:

- All open purchase orders are either closed or voided within an acceptable amount of time.
- The requesting party is notified periodically of the status of the purchase order and the reason for its current status.
- The reason the purchase order remains open is due to incomplete shipment of goods and, if so, whether the vendor has been notified.
- There are quantity problems that should be discussed with purchasing.

b. Observed the performance of the control**.** The auditor observed the employee performing the control for the Unmatched Items Reports generated during the first week in July.

c. Reperformed the control**.** The auditor selected five weekly Unmatched Items Reports, selected several items from each, and reperformed the procedures that the employee performed. The auditor also scanned other Unmatched Items Reports to determine that the control was performed throughout the period of intended reliance.

To determine that the company had not made significant changes in their controls from interim to year-end, the auditor discussed with company personnel the procedures in place for making such changes. Since the procedures had not changed from interim to year-end, the auditor observed that the controls were still in place by scanning the weekly Unmatched Items Reports to determine that the control was performed on a timely basis during the interim to year-end period.

Based on the auditor's procedures, the auditor concluded that the employee was clearing exceptions in a timely manner and that the control was operating effectively as of year-end.

APPENDIX C

Safeguarding of Assets

C1. *Safeguarding of assets* is defined in paragraph 7 as those policies and procedures that "provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements." This definition is consistent with the definition provided in the Committee of Sponsoring Organizations (COSO) of the Treadway Commission's Addendum, *Reporting to External Parties*, which provides the following definition of internal control over safeguarding of assets:

> Internal control over safeguarding of assets against unauthorized acquisition, use or disposition is a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements. Such internal control can be judged effective if the board of directors and management have reasonable assurance that unauthorized acquisition, use or disposition of the entity's assets that could have a material effect on the financial statements is being prevented or detected on a timely basis.

C2. For example, a company has safeguarding controls over inventory tags (preventive controls) and also performs periodic physical inventory counts (detective control) timely in relation to its quarterly and annual financial reporting dates. Although the physical inventory count does not safeguard the inventory from theft or loss, it prevents a material misstatement to the financial statements if performed effectively and timely.

C3. Therefore, given that the definitions of material weakness and significant deficiency relate to the likelihood of misstatement of the financial statements, the failure of a preventive control such as inventory tags will not result in a significant deficiency or material weakness if the detective control (physical inventory) prevents a misstatement of the financial statements. The COSO Addendum also indicates that to the extent that such losses might occur, controls over financial reporting are effective if they provide reasonable assurance that those losses are properly reflected in the financial statements, thereby alerting financial statement users to consider the need for action.

> Note: *Properly reflected* in the financial statements includes both correctly recording the loss and adequately disclosing the loss.

C4. Material weaknesses relating to controls over the safeguarding of assets would only exist when the company does not have effective controls (considering both safeguarding and other controls) to prevent or detect a material misstatement of the financial statements.

C5. Furthermore, management's plans that could potentially affect financial reporting in future periods are not controls. For example, a company's business continuity or contingency planning has no effect on the company's current abilities to initiate, authorize, record, process, or report financial data. Therefore, a company's business continuity or contingency planning is not part of internal control over financial reporting.

C6. The COSO Addendum provides further information about safeguarding of assets as it relates to internal control over financial reporting.

APPENDIX D

Examples of Significant Deficiencies and Material Weaknesses

D1. Paragraph 8 of this standard defines a control deficiency. Paragraphs 9 and 10 go on to define a significant deficiency and a material weakness, respectively.

D2. Paragraphs 22 through 23 of this standard discuss materiality in an audit of internal control over financial reporting, and paragraphs 130 through 140 provide additional direction on evaluating deficiencies in internal control over financial reporting.

D3. The following examples illustrate how to evaluate the significance of internal control deficiencies in various situations. These examples are for illustrative purposes only.

Example D-1— ***Reconciliations of Intercompany Accounts Are Not Performed on a Timely Basis***

Scenario A – Significant Deficiency. The company processes a significant number of routine intercompany transactions on a monthly basis. Individual intercompany transactions are not material and primarily relate to balance sheet activity, for example, cash transfers between business units to finance normal operations.

A formal management policy requires monthly reconciliation of intercompany accounts and confirmation of balances between business units. However, there is not a process in place to ensure performance of these procedures. As a result, detailed reconciliations of intercompany accounts are not performed on a timely basis. Management does perform monthly procedures to investigate selected large-dollar intercompany account differences. In addition, management prepares a detailed monthly variance analysis of operating expenses to assess their reasonableness.

Based only on these facts, the auditor should determine that this deficiency represents a significant deficiency for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be more than inconsequential, but less than material, because individual intercompany transactions are not material, and the compensating controls operating monthly should detect a material misstatement. Furthermore, the transactions are primarily restricted to balance sheet accounts. However, the compensating detective controls are designed only to detect material misstatements. The controls do not address the detection of misstatements that are more than inconsequential but less than material. Therefore, the likelihood that a misstatement that was more than inconsequential, but less than material, could occur is more than remote.

Scenario B - Material Weakness. The company processes a significant number of intercompany transactions on a monthly basis. Intercompany transactions relate to a wide range of activities, including transfers of inventory with intercompany profit between business units, allocation of research and development costs to business units and corporate charges. Individual intercompany transactions are frequently material.

A formal management policy requires monthly reconciliation of intercompany accounts and confirmation of balances between business units. However, there is not a process in place to ensure that these procedures are performed on a consistent basis. As a result, reconciliations of intercompany accounts are not performed on a timely basis, and differences in intercompany accounts are frequent and significant. Management does not perform any alternative controls to investigate significant intercompany account differences.

Based only on these facts, the auditor should determine that this deficiency represents a material weakness for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be material, because individual intercompany transactions are frequently material and relate to a wide range of activities. Additionally, actual unreconciled differences in intercompany accounts have been, and are, material. The likelihood of such a misstatement is more than remote because such misstatements have frequently occurred and compensating controls are not effective, either because they are not properly designed or not operating effectively. Taken together, the magnitude and likelihood of misstatement of the financial statements resulting from this internal control deficiency meet the definition of a material weakness.

Example D-2—***Modifications to Standard Sales Contract Terms Not Reviewed To Evaluate Impact on Timing and Amount of Revenue Recognition***

Scenario A – Significant Deficiency. The company uses a standard sales contract for most transactions. Individual sales transactions are not material to the entity. Sales personnel are allowed to modify sales contract terms. The company's accounting function reviews significant or unusual modifications to the sales contract terms, but does not review changes in the standard shipping terms. The changes in the standard shipping terms could require a delay in the timing of revenue recognition. Management reviews gross margins on a monthly basis and investigates any significant or unusual relationships. In addition, management reviews the reasonableness of inventory levels at the end of each accounting period. The entity has experienced limited situations in which revenue has been inappropriately recorded in advance of shipment, but amounts have not been material.

Based only on these facts, the auditor should determine that this deficiency represents a significant deficiency for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be more than inconsequential, but less than material, because individual sales transactions are not material and the compensating detective controls operating monthly and at the end of each financial reporting period should reduce the likelihood of a material misstatement going undetected. Furthermore, the risk of material misstatement is limited to revenue recognition errors related to shipping terms as opposed to broader sources of error in revenue recognition. However, the compensating detective controls are only designed to detect material misstatements. The controls do not effectively address the detection of misstatements that are more than inconsequential but less than material, as evidenced by situations in which transactions that were not material were improperly recorded. Therefore, there is a more than remote likelihood that a misstatement that is more than inconsequential but less than material could occur.

Scenario B - Material Weakness. The company has a standard sales contract, but sales personnel frequently modify the terms of the contract. The nature of the modifications can affect the timing and amount of revenue recognized. Individual sales transactions are frequently material to the entity, and the gross margin can vary significantly for each transaction.

The company does not have procedures in place for the accounting function to regularly review modifications to sales contract terms. Although management reviews gross margins on a monthly basis, the significant differences in gross margins on individual transactions make it difficult for management to identify potential misstatements. Improper revenue recognition has occurred, and the amounts have been material.

Based only on these facts, the auditor should determine that this deficiency represents a material weakness for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be material, because individual sales transactions are frequently material, and gross margin can vary significantly with each transaction (which would make compensating detective controls based on a reasonableness review ineffective). Additionally, improper revenue recognition has occurred, and the amounts have been material. Therefore, the likelihood of material misstatements occurring is more than remote. Taken together, the magnitude and likelihood of misstatement of the financial statements resulting from this internal control deficiency meet the definition of a material weakness.

Scenario C – Material Weakness. The company has a standard sales contract, but sales personnel frequently modify the terms of the contract. Sales personnel frequently grant unauthorized and unrecorded sales discounts to customers without the knowledge of the accounting department. These amounts are deducted by customers in paying their invoices and are recorded as outstanding balances on the accounts receivable aging. Although these amounts are individually insignificant, they are material in the aggregate and have occurred consistently over the past few years.

Based on only these facts, the auditor should determine that this deficiency represents a material weakness for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be material, because the frequency of occurrence allows insignificant amounts to become material in the aggregate. The likelihood of material misstatement of the financial statements resulting from this internal control deficiency is more than remote (even assuming that the amounts were fully reserved for in the company's allowance for uncollectible accounts) due to the likelihood of material misstatement of the gross accounts receivable balance. Therefore, this internal control deficiency meets the definition of a material weakness.

Example D-3—***Identification of Several Deficiencies***

Scenario A – Material Weakness. During its assessment of internal control over financial reporting, management identified the following deficiencies. Based on the context in which the deficiencies occur, management and the auditor agree that these deficiencies individually represent significant deficiencies:

- Inadequate segregation of duties over certain information system access controls.

- Several instances of transactions that were not properly recorded in subsidiary ledgers; transactions were not material, either individually or in the aggregate.

- A lack of timely reconciliations of the account balances affected by the improperly recorded transactions.

Based only on these facts, the auditor should determine that the combination of these significant deficiencies represents a material weakness for the following reasons: Individually, these deficiencies were evaluated as representing a more than remote likelihood that a misstatement that is more than inconsequential, but less than material, could occur. However, each of these significant deficiencies affects the same set of accounts. Taken together, these significant deficiencies represent a more than remote likelihood that a material misstatement could occur and not be prevented or detected. Therefore, in combination, these significant deficiencies represent a material weakness.

Scenario B – Material Weakness. During its assessment of internal control over financial reporting, management of a financial institution identifies deficiencies in: the design of controls over the estimation of credit losses (a critical accounting estimate); the operating effectiveness of controls for initiating, processing, and reviewing adjustments to the allowance for credit losses; and the operating effectiveness of controls designed to prevent and detect the improper recognition of interest income. Management and the auditor agree that, in their overall context, each of these deficiencies individually represent a significant deficiency.

In addition, during the past year, the company experienced a significant level of growth in the loan balances that were subjected to the controls governing credit loss estimation and revenue recognition, and further growth is expected in the upcoming year.

Based only on these facts, the auditor should determine that the combination of these significant deficiencies represents a material weakness for the following reasons:

- The balances of the loan accounts affected by these significant deficiencies have increased over the past year and are expected to increase in the future.

- This growth in loan balances, coupled with the combined effect of the significant deficiencies described, results in a more than remote likelihood that a material misstatement of the allowance for credit losses or interest income could occur.

Therefore, in combination, these deficiencies meet the definition of a material weakness.

APPENDIX E

BACKGROUND AND BASIS FOR CONCLUSIONS

Table of Contents — ***Paragraph***

Introduction

E1. This appendix summarizes factors that the Public Company Accounting Oversight Board (the "Board") deemed significant in reaching the conclusions in the standard. This appendix includes reasons for accepting certain views and rejecting others.

Background

E2. Section 404(a) of the Sarbanes-Oxley Act of 2002 (the "Act"), and the Securities and Exchange Commission's (SEC) related implementing rules, require the management of a public company to assess the effectiveness of the company's internal control over financial reporting, as of the end of the company's most recent fiscal year. Section 404(a) of the Act also requires management to include in the company's annual report to shareholders management's conclusion as a result of that assessment of whether the company's internal control over financial reporting is effective.

E3. 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.

E4. The backdrop for the development of the Board's first major auditing standard was, of course, the spectacular audit failures and corporate malfeasance that led to the passage of the Act. Although all of the various components of the Act work together to help restore investor confidence and help prevent the types of financial reporting breakdowns that lead to the loss of investor confidence, Section 404 of the Act is certainly one of the most visible and tangible changes required by the Act.

E5. The Board believes that effective controls provide the foundation for reliable financial reporting. Congress believed this too, which is why the new reporting by management and the auditor on the effectiveness of internal control over financial reporting received such prominent attention in the Act. Internal control over financial reporting enhances a company's ability to produce fair and complete financial reports. Without reliable financial reports, making good judgments and decisions about a company becomes very difficult for anyone, including the board of directors, management, employees, investors, lenders, customers, and regulators. The auditor's reporting on management's assessment of the effectiveness of internal control over financial reporting provides users of that report with important assurance about the reliability of the company's financial reporting.

E6. The Board's efforts to develop this standard were an outward expression of the Board's mission, "to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports." As part of fulfilling that mission as it relates to this standard, the Board considered the advice that respected groups had offered to other auditing standards setters in the past. For example, the Public Oversight Board's Panel on Audit Effectiveness recommended that "auditing standards need to provide clear, concise and definitive imperatives for auditors to follow."[39/] As another example, the International Organization of Securities Commissioners advised the International Auditing and Assurance Standards Board "that the IAASB must take care to avoid language that could inadvertently encourage inappropriate shortcuts in audits, at a time when rigorous audits are needed more than ever to restore investor confidence."[40/]

[39/] Panel on Audit Effectiveness, *Report and Recommendations*, sec. 2.228 (August 31, 2000).

[40/] April 8, 2003 comment letter from the International Organization of Securities Commissions to the International Auditing and Assurance Standards Board regarding the proposed international standards on audit risk (Amendment to ISA 200, "Objective and Principles Governing an Audit of Financial Statements;" proposed ISAs, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement;" "Auditor's Procedures in Response to Assessed Risks;" and "Audit Evidence").

E7. The Board understood that, to effectively fulfill its mission and for this standard to achieve its ultimate goal of restoring investor confidence by increasing the reliability of public company financial reporting, the Board's standard must contain clear directions to the auditor consistent with investor's expectations that the reliability of financial reporting be significantly improved. Just as important, the Board recognized that this standard must appropriately balance the costs to implement the standard's directions with the benefits of achieving these important goals. As a result, all of the Board's decisions about this standard were guided by the additional objective of creating a rational relationship between costs and benefits.

E8. When the Board adopted its interim attestation standards in Rule 3300T on an initial, transitional basis, the Board adopted a pre-existing standard governing an auditor's attestation on internal control over financial reporting.[41/] As part of the Board's process of evaluating that pre-existing standard, the Board convened a public roundtable discussion on July 29, 2003 to discuss issues and hear views related to reporting on internal control over financial reporting. The participants at the roundtable included representatives from public companies, accounting firms, investor groups, and regulatory organizations. Based on comments made at the roundtable, advice from the Board's staff, and other input the Board received, the Board determined that the pre-existing standard governing an auditor's attestation on internal control over financial reporting was insufficient for effectively implementing the requirements of Section 404 of the Act and for the Board to appropriately discharge its standard-setting obligations under Section 103(a) of the Act. In response, the Board developed and issued, on October 7, 2003, a proposed auditing standard titled, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements.*

E9. The Board received 189 comment letters on a broad array of topics from a variety of commenters, including auditors, investors, internal auditors, issuers, regulators, and others. Those comments led to changes in the standard, intended to make the requirements of the standard clearer and more operational. This appendix summarizes significant views expressed in those comment letters and the Board's responses.

Fundamental Scope of the Auditor's Work in an Audit of Internal Control over Financial Reporting

E10. The proposed standard stated that the auditor's objective in an audit of internal control over financial reporting was to express an opinion on

41/ The pre-existing standard is Chapter 5, "*Reporting on an Entity's Internal Control Over Financial Reporting*" of Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards,* Vol. 1, AT sec. 501). SSAE No. 10 has been codified into AICPA *Professional Standards,* Volume 1, as AT sections 101 through 701.

management's assessment of the effectiveness of the company's internal control over financial reporting. To render such an opinion, the proposed standard required the auditor to obtain reasonable assurance about whether the company maintained, in all material respects, effective internal control over financial reporting as of the date specified in management's report. To obtain reasonable assurance, the auditor was required to evaluate both management's process for making its assessment and the effectiveness of internal control over financial reporting.

E11. Virtually all investors and auditors who submitted comment letters expressed support for this approach. Other commenters, primarily issuers, expressed concerns that this approach was contrary to the intent of Congress and, therefore, beyond what was specifically required by Section 404 of the Act. Further, issuers stated their views that this approach would lead to unnecessary and excessive costs. Some commenters in this group suggested the auditor's work should be limited to evaluating management's assessment process and the testing performed by management and internal audit. Others acknowledged that the auditor would need to test at least some controls directly in addition to evaluating and testing management's assessment process. However, these commenters described various ways in which the auditor's own testing could be significantly reduced from the scope expressed in the proposed standard. For instance, they proposed that the auditor could be permitted to use the work of management and others to a much greater degree; that the auditor could use a "risk analysis" to identify only a few controls to be tested; and a variety of other methods to curtail the extent of the auditor's work. Of those opposed to the scope, most cited their belief that the scope of work embodied in the standard would lead to a duplication of effort between management and the auditor which would needlessly increase costs without adding significant value.

E12. After considering the comments, the Board retained the approach described in the proposed standard. The Board concluded that the approach taken in the standard is consistent with the intent of Congress. Also, to provide the type of report, at the level of assurance called for in Sections 103 and 404, the Board concluded that the auditor must evaluate both management's assessment process and the effectiveness of internal control over financial reporting. Finally, the Board noted the majority of the cost to be borne by companies (and ultimately investors) results directly from the work the company will have to perform to maintain effective internal control over financial reporting and to comply with Section 404(a) of the Act. The cost of the auditor's work as described in this standard ultimately will represent a smaller portion of the total cost to companies of implementing Section 404.

E13. The Board noted that large, federally insured financial institutions have had a similar internal control reporting requirement for over ten years. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) has required, since 1993, managements of large financial institutions to make an assessment of internal control over financial reporting effectiveness and the institution's independent auditor to issue an attestation report on management's assessment.

E14. The attestation standards under which FDICIA engagements are currently performed are clear that, when performing an examination of management's assertion on the effectiveness of internal control over financial reporting (management's report on the assessment required by Section 404(a) of the Act must include a statement as to whether the company's internal control over financial reporting is effective), the auditor may express an opinion either on management's assertion (that is, whether management's assessment about the effectiveness of the internal control over financial reporting is fairly stated) or directly on the subject matter (that is, whether the internal control over financial reporting is effective) because the level of work that must be performed is the same in either case.

E15. The Board observed that Congress indicated an intent to require an examination level of work in Section 103(a) of the Act, which states, in part, that each registered public accounting firm shall:

> describe in each audit report the scope of the auditor's testing of the internal control structure and procedures of the issuer, required by Section 404(b), and present (in such report or in a separate report)—
>
> (I) the findings of the auditor from such testing;
>
> **(II) an evaluation of whether such internal control structure and procedures—**
>
> **(aa) include maintenance of records that in reasonable detail accurately reflect the transactions and dispositions of the assets of the issuer;**
>
> **(bb) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer**; and
>
> (III) a description, at a minimum, of material weaknesses in such internal controls, and of any material noncompliance found on the basis of such testing. [emphasis added].

E16. The Board concluded that the auditor must test internal control over financial reporting directly, in the manner and extent described in the standard, to make the evaluation described in Section 103. The Board also interpreted

Section 103 to provide further support that the intent of Congress was to require an opinion on the effectiveness of internal control over financial reporting.

E17. The Board concluded that the auditor must obtain a high level of assurance that the conclusion expressed in management's assessment is correct to provide an opinion on management's assessment. An auditing process restricted to evaluating what management has done would not provide the auditor with a sufficiently high level of assurance that management's conclusion is correct. Instead, it is necessary for the auditor to evaluate management's assessment process to be satisfied that management has an appropriate basis for its statement, or assertion, about the effectiveness of the company's internal control over financial reporting. It also is necessary for the auditor to directly test the effectiveness of internal control over financial reporting to be satisfied that management's conclusion is correct, and that management's assertion is fairly stated.

E18. This testing takes on added importance with the public nature of the internal control reporting. Because of the auditor's association with a statement by management that internal control over financial reporting is effective, it is reasonable for a user of the auditor's report to expect that the auditor tested the effectiveness of internal control over financial reporting. For the auditor to do otherwise would create an expectation gap, in which the assurance that the auditor obtained is less than what users reasonably expect.

E19. Auditors, investors, and the Federal bank regulators reaffirmed in their comment letters on the proposed auditing standard that the fundamental approach taken by the Board was appropriate and necessary. Investors were explicit in their expectation that the auditor must test the effectiveness of controls directly in addition to evaluating management's assessment process. Investors further recognized that this kind of assurance would come at a price and expressed their belief that the cost of the anticipated benefits was reasonable. The federal banking regulators, based on their experience examining financial institutions' internal control assessments and independent auditors' attestation reports under FDICIA, commented that the proposed auditing standard was a significant improvement over the existing attestation standard.

Reference to Audit vs. Attestation

E20. The proposed standard referred to the attestation required by Section 404(b) of the Act as the *audit* of internal control over financial reporting instead of an *attestation* of management's assessment. The proposed standard took that approach both because the auditor's objective is to express an opinion on management's assessment of the effectiveness of internal control over financial reporting, just as the auditor's objective in an audit of the financial statements is to express an opinion on the fair presentation of the financial statements, and because the level of assurance obtained by the auditor is the same in both cases. Furthermore, the proposed standard described an *integrated* audit of the financial statements and internal control over financial reporting and allowed the auditor to express his or her opinions on the financial statements and on the effectiveness of internal control in separate reports or in a single, combined report.

E21. Commenters' views on this matter frequently were related to their views on whether the proposed scope of the audit was appropriate. Those who agreed that the scope in the proposed standard was appropriate generally agreed that referring to the engagement as an *audit* was appropriate. On the other hand, commenters who objected to the scope of work described in the proposed standard often drew an important distinction between an *audit* and an *attestation.* Because Section 404 calls for an *attestation*, they believed it was inappropriate to call the engagement anything else (or to mandate a scope that called for a more extensive level of work).

E22. Based, in part, on the Board's decisions about the scope of the audit of internal control over financial reporting, the Board concluded that the engagement should continue to be referred to as an "audit." This term emphasizes the nature of the auditor's objective and communicates that objective most clearly to report users. Use of this term also is consistent with the integrated approach described in the standard and the requirement in Section 404 of the Act that this reporting not be subject to a separate engagement.

E23. Because the Board's standard on internal control is an auditing standard, it is preferable to use the term *audit* to describe the engagement rather than the term *examination*, which is used in the attestation standards to describe an engagement designed to provide a high level of assurance.

E24. Finally, the Board believes that using the term *audit* helps dispel the misconception that an audit of internal control over financial reporting is a different level of service than an attestation of management's assessment of internal control over financial reporting.

Form of the Auditor's Opinion

E25. The proposed auditing standard required that the auditor's opinion in his or her report state whether management's assessment of the effectiveness of the company's internal control over financial reporting as of the specified date is fairly stated, in all material respects, based on the control criteria. However, the proposed standard also stated that nothing precluded the auditor from auditing management's assessment and opining directly on the effectiveness of internal control over financial reporting. This is because the scope of the work, as defined by the proposed standard, was the same, regardless of whether the auditor reports on management's assessment or directly on the effectiveness of internal control over financial reporting. The form of the opinion was essentially interchangeable between the two.

E26. However, if the auditor planned to issue other than an unqualified opinion, the proposed standard required the auditor to report directly on the effectiveness of the company's internal control over financial reporting rather than on management's assessment. The Board initially concluded that expressing an opinion on management's assessment, in these circumstances, did not most effectively communicate the auditor's conclusion that internal control was not effective. For example, if management expresses an adverse assessment because a material weakness exists at the date of management's assessment ("…internal control over financial reporting is not effective…") and the auditor expresses his or her opinion on management's assessment ("…management's assessment that internal control over financial reporting is not effective is fairly stated, in all material respects…"), a reader might not be clear about the results of the auditor's testing and about the auditor's conclusions. The Board initially decided that reporting directly on the effectiveness of the company's internal control over financial reporting better communicates to report users the effect of such conditions, because direct reporting more clearly states the auditor's conclusions about the effectiveness of internal control over financial reporting ("In our opinion, because of the effect of the material weakness described…, the Company's internal control over financial reporting is not effective.").

E27. A number of commenters were supportive of the model described in the previous paragraph, as they agreed with the Board's reasoning. However, several commenters believed that report users would be confused as to why the form of the auditor's opinion would be different in various circumstances. These commenters thought that the auditor's opinion should be consistently expressed in all reports. Several auditors recommended that auditors always report directly on the effectiveness of the company's internal control over financial reporting. They reasoned that the scope of the audit—which always would require the auditor to obtain reasonable assurance about whether the internal control over financial reporting was effective—would be more clearly communicated, in all cases, by the auditor reporting directly on the effectiveness of internal control over financial reporting. Other commenters suggested that the auditor always should express two opinions: one on management's assessment and one directly on the effectiveness of internal control over financial reporting. They believed the Act called for two opinions: Section 404 calls for an opinion on management's assessment, while Section 103 calls for an opinion directly on the effectiveness of internal control over financial reporting.

E28. The Board believes that the reporting model in the proposed standard is appropriate. However, the Board concluded that the expression of two opinions—one on management's assessment and one on the effectiveness of internal control over financial reporting—in all reports is a superior approach that balances the concerns of many different interested parties. This approach is consistent with the scope of the audit, results in more consistent reporting in differing circumstances, and makes the reports more easily understood by report users. Therefore, the standard requires that the auditor express two opinions in all reports on internal control over financial reporting.

Use of the Work of Others

E29. After giving serious consideration to a rational relationship between costs and benefits, the Board decided to change the provisions in the proposed standard regarding using the work of others. The proposed standard required the auditor to evaluate whether to use the work of others, such as internal auditors and others working under the direction of management, and described an evaluation process focused on the competence and objectivity of the persons who performed the work that the auditor was required to use when determining the extent to which he or she could use the work of others.

E30. The proposed standard also described two principles that limited the auditor's ability to use of the work of others. First, the proposed standard defined three categories of controls and the extent to which the auditor could use the work of others in each of those categories:

- Controls for which the auditor should not rely on the work of others, such as controls in the control environment and controls specifically intended to prevent or detect fraud that is reasonably likely to have a material effect on the company's financial statements,

- Controls for which the auditor may rely on the work of others, but his or her reliance on the work of others should be limited, such as controls over nonroutine transactions that are considered high risk because they involve judgments and estimates, and

- Controls for which the auditor's reliance on the work of others is not specifically limited, such as controls over routine processing of significant accounts.

E31. Second, the proposed standard required that, on an overall basis, the auditor's own work must provide the principal evidence for the audit opinion (this is referred to as the *principal evidence provision*).

E32. In the proposed standard, these two principles provided the auditor with flexibility in using the work of others while preventing him or her from placing inappropriate over-reliance on the work of others. Although the proposed standard required the auditor to reperform some of the tests performed by others to use their work, it did not establish specific requirements for the extent of the reperformance. Rather, it allowed the auditor to use his or her judgment and the directions provided by the two principles discussed in the previous two paragraphs to determine the appropriate extent of reperformance.

E33. The Board received a number of comments that agreed with the proposed three categories of controls and the principal evidence provision. However, most commenters expressed some level of concern with the categories, the principal evidence provision, or both.

E34. Comments opposing or criticizing the categories of controls varied from general to very specific. In general terms, many commenters (particularly issuers) expressed concern that the categories described in the proposed standard were too restrictive. They believed the auditor should be able to use his or her judgment to determine in which areas and to what extent to rely on the work of others. Other commenters indicated that the proposed standard did not place enough emphasis on the work of internal auditors whose competence and objectivity, as well as adherence to professional standards of internal auditing, should clearly set their work apart from the work performed by others in the organization (such as management or third parties working under management's direction). Further, these commenters believed that the standard should clarify that the auditor should be able to use work performed by internal auditors extensively. In that case, their concerns about excessive cost also would be partially alleviated.

E35. Other commenters expressed their belief that the proposed standard repudiated the approach established in AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,* for the auditor's use of the work of internal auditors in a financial statement audit. Commenters also expressed very specific and pointed views on the three categories of controls. As defined in the proposed standard, the first category (in which the auditor should not use the work of others at all) included:

- Controls that are part of the control environment, including controls specifically established to prevent and detect fraud that is reasonably likely to result in material misstatement of the financial statements.

- Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; to initiate, record, and process journal entries in the general ledger; and to record recurring and nonrecurring adjustments to the financial statements (for example, consolidating adjustments, report combinations, and reclassifications).

- 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.

- Walkthroughs.

E36. Commenters expressed concern that the prohibition on using the work of others in these areas would (a) drive unnecessary and excessive costs, (b) not give appropriate recognition to those instances in which the auditor evaluated internal audit as having a high degree of competence and objectivity, and (c) be impractical due to resource constraints at audit firms. Although each individual area was mentioned, the strongest and most frequent objections were to the restrictions imposed over the inclusion in the first category of walkthroughs, controls over the period-end financial reporting process, and information technology general controls. Some commenters suggested the Board should consider moving these areas from the first category to the second category (in which using the work of others would be limited, rather than prohibited); others suggested removing any limitation on using the work of others in these areas altogether.

E37. Commenters also expressed other concerns with respect to the three control categories. Several commenters asked for clarification on what constituted *limited* use of the work of others for areas included in the second category. Some commenters asked for clarification about the extent of reperformance necessary for the auditor to use the work of others. Other commenters questioned the meaning of the term *without specific limitation* in the third category by asking, did this mean that the auditor could use the work of others in these areas without performing *or* reperforming *any* work in those areas?

E38. Although most commenters suggested that the principal evidence threshold for the auditor's own work be retained, some commenters objected to the principal evidence provision. Although many commenters identified the broad array of areas identified in the first category (in which the auditor should not use the work of others at all) as the key driver of excessive costs, others identified the principal evidence provision as the real source of their excessive cost concerns. Even if the categories were redefined in such a way as to permit the auditor to use the work of others in more areas, any associated decrease in audit cost would be limited by the principal evidence provision which, if retained, would still require significant original work on the part of the auditor. On the other hand, both investors and auditors generally supported retaining the principal evidence provision as playing an important role in ensuring the independence of the auditor's opinion and preventing inappropriate overreliance on the work of internal auditors and others.

E39. Commenters who both supported and opposed the principal evidence provision indicated that implementing it would be problematic because the nature of the work in an audit of internal control over financial reporting does not lend itself to a purely quantitative measurement. Thus, auditors would be forced to use judgment when determining whether the principal evidence provision has been satisfied.

E40. In response to the comments, the Board decided that some changes to the guidance on using the work of others were necessary. The Board did not intend to reject the concepts in AU sec. 322 and replace them with a different model. Although AU sec. 322 is designed to apply to an audit of financial statements, the Board concluded that the concepts contained in AU sec. 322 are sound and should be used in an audit of internal control over financial reporting, with appropriate modification to take into account the differences in the nature of the evidence necessary to support an opinion on financial statements and the evidence necessary to support an opinion on internal control effectiveness. The Board also wanted to make clear that the concepts in AU sec. 322 also may be applied, with appropriate auditor judgment, to the relevant work of others.

E41. The Board remained concerned, however, with the possibility that auditors might overrely on the work of internal auditors and others. Inappropriate overreliance can occur in a variety of ways. For example, an auditor might rely on the work of a highly competent and objective internal audit function for proportionately too much of the evidence that provided the basis for the auditor's opinion. Inappropriate overreliance also occurs when the auditor incorrectly concludes that internal auditors have a high degree of competence and objectivity when they do not, perhaps because the auditor did not exercise professional skepticism or due professional care when making his or her evaluation. In either case, the result is the same: unacceptable risk that the auditor's conclusion that internal control over financial reporting is effective is incorrect. For example, federal bank regulators commented that, in their experience with FDICIA, auditors have a tendency to rely too heavily on the work of management and others, further noting that this situation diminishes the independence of the auditor's opinion on control effectiveness.

E42. The Board decided to revise the categories of controls by focusing on the nature of the controls being tested, evaluating the competence and objectivity of the individuals performing the work, and testing the work of others. This allows the auditor to exercise substantial judgment based on the outcome of this work as to the extent to which he or she can make use of the work of internal auditors or others who are suitably qualified.

E43. This standard emphasizes the direct relationship between the assessed level of competence and objectivity and the extent to which the auditor may use the work of others. The Board included this clarification to highlight the special status that a highly competent and objective internal auditor has in the auditor's work as well as to caution against inappropriate overreliance on the work of management and others who would be expected to have lower degrees of competence and objectivity in assessing controls. Indeed, the Board noted that, with regard to internal control over financial reporting, internal auditors would normally be assessed as having a higher degree of competence and objectivity than management or others and that an auditor will be able to rely to a greater extent on the work of a highly competent and objective internal auditor than on work performed by others within the company.

E44. The Board concluded that the principal evidence provision is critical to preventing overreliance on the work of others in an audit of internal control over financial reporting. The requirement for the auditor to perform enough of the control testing himself or herself so that the auditor's own work provides the principal evidence for the auditor's opinion is of paramount importance to the auditor's assurance providing the level of reliability that investors expect. However, the Board also decided that the final standard should articulate clearly that the auditor's judgment about whether he or she has obtained the principal evidence required is qualitative as well as quantitative. Therefore, the standard now states, "Because the amount of work related to obtaining sufficient evidence to support an opinion about the effectiveness of controls is not susceptible to precise measurement, the auditor's judgment about whether he or she has obtained the principal evidence for the opinion will be qualitative as well as quantitative. For example, the auditor might give more weight to work performed on pervasive controls and in areas such as the control environment than on other controls, such as controls over low-risk, routine transactions."

E45. The Board also concluded that a better balance could be achieved in the standard by instructing the auditor to factor into the determination of the extent to which to use the work of others an evaluation of the nature of the controls on which others performed their procedures.

E46. Paragraph 112 of the standard provides the following factors the auditor should consider when evaluating the nature of the controls subjected to the work of others:

- The materiality of the accounts and disclosures that the control addresses and the risk of material misstatement.

- The degree of judgment required to evaluate the operating effectiveness of the control (that is, the degree to which the evaluation of the effectiveness of the control requires evaluation of subjective factors rather than objective testing).

- The pervasiveness of the control.

- The level of judgment or estimation required in the account or disclosure.

- The potential for management override of the control.

E47. As these factors increase in significance, the need for the auditor to perform his or her own work on those controls increases. As these factors decrease in significance, the auditor may rely more on the work of others. Because of the nature of controls in the control environment, however, the standard does not allow the auditor to use the work of others to reduce the amount of work he or she performs on such controls. In addition, the standard also does not allow the auditor to use the work of others in connection with the performance of walkthroughs of major classes of transactions because of the high degree of judgment required when performing them (See separate discussion in paragraphs E51 through E57).

E48. The Board decided that this approach was responsive to those who believed that the auditor should be able to use his or her judgment in determining the extent to which to use the work of others. The Board designed the requirement that the auditor's own work must provide the principal evidence for the auditor's opinion as one of the boundaries within which the auditor determines the work he or she must perform himself or herself in the audit of internal control over financial reporting. The other instructions about using the work of others provide more specific direction about how the auditor makes this determination, but allow the auditor significant flexibility to use his or her judgment to determine the work necessary to obtain the principal evidence, and to determine when the auditor can use the work of others rather than perform the work himself or herself. Although some of the directions are specific and definitive, such as the directions for the auditor to perform tests of controls in the control environment and walkthroughs himself or herself, the Board decided that these areas were of such audit importance that the auditor should always perform this testing as part of obtaining the principal evidence for his or her opinion. The Board concluded that this approach appropriately balances the use of auditor judgment and the risk of inappropriate overreliance.

E49. The Board was particularly concerned by comments that issuers might choose to reduce their internal audit staff or the extent of internal audit testing in the absence of a significant change in the proposed standard that would significantly increase the extent to which the auditor may use the work of internal auditors. The Board believes the standard makes clear that an effective internal audit function does permit the auditor to reduce the work that otherwise would be necessary.

E50. Finally, as part of clarifying the linkage between the degree of competence and objectivity of the others and the ability to use their work, the Board decided that additional clarification should be provided on the extent of testing that should be required of the work of others. The Board noted that the interaction of the auditor performing walkthroughs of every significant process and the retention of the principal evidence provision precluded the need for the auditor to test the work of others in every significant account. However, testing the work of others is an important part of an ongoing assessment of their competence and objectivity. Therefore, as part of the emphasis on the direct relationship between the assessed level of competence and objectivity to the extent of the use of the work of others, additional provisions were added discussing how the results of the testing of the work of others might affect the auditor's assessment of competence and objectivity. The Board also concluded that testing the work of others should be clearly linked to an evaluation of the quality and effectiveness of their work.

Walkthroughs

E51. The proposed standard included a requirement that the auditor perform walkthroughs, stating that the auditor should perform a walkthrough for all of the company's significant processes. In the walkthrough, the auditor was to trace all types of transactions and events, both recurring and unusual, from origination through the company's information systems until they were included in the company's financial reports. As stated in the proposed standard, walkthroughs provide the auditor with evidence to:

- Confirm the auditor's understanding of the process flow of transactions;
- Confirm the auditor's understanding of the design of controls identified for all five components of internal control over financial reporting, including those related to the prevention or detection of fraud;
- Confirm that the auditor's understanding of the process is complete by determining whether all points in the process at which misstatements related to each relevant financial statement assertion that could occur have been identified;
- Evaluate the effectiveness of the design of controls; and
- Confirm whether controls have been placed in operation.

E52. A number of commenters expressed strong support for the requirement for the auditor to perform walkthroughs as described in the proposed standard. They agreed that auditors who did not already perform the type of walkthrough described in the proposed standard should perform them as a matter of good practice. These commenters further recognized that the first-hand understanding an auditor obtains from performing these walkthroughs puts the auditor in a much better position to design an effective audit and to evaluate the quality and effectiveness of the work of others. They considered the walkthrough requirement part of "getting back to basics," which they viewed as a positive development.

E53. Some commenters expressed general support for walkthroughs as required procedures, but had concerns about the scope of the work. A number of commenters suggested that requiring walkthroughs of *all* significant processes and *all* types of transactions would result in an overwhelming and unreasonable number of walkthroughs required. Commenters made various suggestions for alleviating this problem, including permitting the auditor to determine, using broad auditor judgment, which classes of transactions to walk through or refining the scope of "all types of transactions" to include some kind of consideration of risk and materiality.

E54. Other commenters believed that required walkthroughs would result in excessive cost if the auditor were prohibited from using the work of others. These commenters suggested that the only way that required walkthroughs would be a reasonable procedure is to permit the auditor to use the work of others. Although commenters varied on whether the auditor's use of the work of others for walkthroughs should be liberal or limited, and whether it should include management or be limited to internal auditors, a large number of commenters suggested that limiting walkthroughs to only the auditor himself or herself was impractical.

E55. The Board concluded that the objectives of the walkthroughs cannot be achieved second-hand. For the objectives to be effectively achieved, the auditor must perform the walkthroughs himself or herself. Several commenters who objected to the prohibition on using the work of internal auditors for walkthroughs described situations in which internal auditors would be better able to effectively perform walkthroughs because internal auditors understood the company's business and controls better than the external auditor and because the external auditor would struggle in performing walkthroughs due to a lack of understanding. The Board observed that these commenters' perspectives support the importance of requiring the external auditor to perform walkthroughs. If auditors struggle to initially perform walkthroughs because their knowledge of the company and its controls is weak, then that situation would only emphasize the necessity for the auditor to increase his or her level of understanding. After considering the nature and extent of the procedures that would be required to achieve these objectives, the Board concluded that performing walkthroughs would be the most efficient means of doing so. The first-hand understanding the auditor will obtain of the company's processes and its controls through the walkthroughs will translate into increased effectiveness and quality throughout the rest of the audit, in a way that cannot be achieved otherwise.

E56. The Board also decided that the scope of the transactions that should be subjected to walkthroughs should be more narrowly defined. To achieve the objectives the Board intended for walkthroughs to accomplish, the auditor should not be forced to perform walkthroughs on what many commenters reasoned was an unreasonably large population. The Board decided that the auditor should be able to use judgment in considering risk and materiality to determine which transactions and events within a given significant process to walk through. As a result, the directions in the standard on determining significant processes and major classes of transactions were expanded, and the population of transactions for which auditors will be required to walk through narrowed by replacing "all types of transactions" with "major classes of transactions."

E57. Although judgments of risk and materiality are inherent in identifying major classes of transactions, the Board decided to also remove from the standard the statement, "walkthroughs are required procedures" as a means of further clarifying that auditor judgment plays an important role in determining the major classes of transactions for which to perform a walkthrough. The Board observed that leading off the discussion of walkthroughs in the standard with such a sentence could be read as setting a tone that diminished the role of judgment in selecting the transactions to walk through. As a result, the directions in the standard on performing walkthroughs begin with, "The auditor should perform at least one walkthrough for each major class of transactions…" The Board's decision to eliminate the statement "walkthroughs are required procedures" should not be viewed as an indication that performing walkthroughs are optional under the standard's directions. The Board believes the auditor might be able to achieve the objectives of a walkthrough by performing a combination of procedures, including inquiry, inspection, observation, and reperformance; however, performing a walkthrough represents the most efficient and effective means of doing so. The auditor's work on the control environment and walkthroughs is an important part of the principal evidence that the auditor must obtain himself or herself.

Small Business Issues

E58. Appendix E of the proposed standard discussed small and medium-sized company considerations. Comments were widely distributed on this topic. A number of commenters indicated that the proposed standard gave adequate 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 companies. Other commenters, particularly smaller issuers and smaller audit firms, indicated that the proposed standard needed to provide much more detail on how internal control over financial reporting could be different at a small or medium-sized issuer and how the auditor's approach could differ. Some of these commenters indicated that the concepts articulated in the Board's proposing release concerning accommodations for small and medium-sized companies were not carried through to the proposed standard itself.

E59. On the other hand, other commenters, particularly large audit firms and investors, expressed views that the proposed standard went too far in creating too much of an accommodation for small and medium-sized issuers. In fact, many believed that the proposed standard permitted those issuers to have less effective internal control over financial reporting than larger issuers, while providing guidance to auditors permitting them to perform less extensive testing at those small and medium-sized issuers than they might have at larger issuers. These commenters stressed that effective internal control over financial reporting is equally important at small and medium-sized issuers. Some commenters also expressed concerns that the guidance in proposed Appendix E appeared to emphasize that the actions of senior management, if carried out with integrity, could offset deficiencies in internal control over financial reporting, such as the lack of written policies and procedures. Because the risk of management override of controls is higher in these types of environments, such commenters were concerned that the guidance in proposed Appendix E might result in an increased fraud risk at small and medium-sized issuers. At a minimum, they argued, the interpretation of Appendix E might result in a dangerous expectation gap for users of their internal control reports. Some commenters who were of this view suggested that Appendix E be deleted altogether or replaced with a reference to the report of the Committee of Sponsoring Organizations (COSO) of the Treadway Commission, *Internal Control—Integrated Framework*, which they felt contained sufficient guidance on small and medium-sized company considerations.

E60. Striking an appropriate balance regarding the needs of smaller issuers is particularly challenging. The Board considered cautionary views about the difficulty in expressing accommodations for small and medium-sized companies without creating an inappropriate second class of internal control effectiveness and audit assurance. Further, the Board noted that the COSO framework currently provides management and the auditor with more guidance and flexibility regarding small and medium-sized companies than the Board had provided in the proposed Appendix E. As a result, the Board eliminated proposed Appendix E and replaced the appendix with a reference to COSO in paragraph 15 of the standard. The Board believes providing internal control criteria for small and medium-sized companies within the internal control framework is more appropriately within the purview of COSO. Furthermore, the COSO report was already tailored for special small and medium-sized company considerations. The Board decided that emphasizing the existing guidance within COSO was the best way of recognizing the special considerations that can and should be given to small and medium-sized companies without inappropriately weakening the standard to which these smaller entities should, nonetheless, be held. If additional tailored guidance on the internal control framework for small and medium-sized companies is needed, the Board encourages COSO, or some other appropriate body, to develop this guidance.

Evaluation of the Effectiveness of the Audit Committee

E61. The proposed standard identified a number of circumstances that, because of their likely significant negative effect on internal control over financial reporting, are significant deficiencies as well as *strong indicators* that a material weakness exists. A particularly notable significant deficiency and strong indicator of a material weakness was the ineffective oversight by the audit committee of the company's external financial reporting and internal control over financial reporting. In addition, the proposed standard required the auditor to evaluate factors related to the effectiveness of the audit committee's oversight of the external financial reporting process and the internal control over financial reporting.

E62. This provision related to evaluating the effectiveness of the audit committee was included in the proposed standard for two primary reasons. First, the Board initially decided that, because of the significant role that the audit committee has in the control environment and monitoring components of internal control over financial reporting, an ineffective audit committee is a gravely serious control weakness that is strongly indicative of a material weakness. Most auditors should have already been reaching this conclusion when confronted with an obviously ineffective audit committee. Second, highlighting the adverse consequences of an ineffective audit committee would, perhaps, further encourage weak audit committees to improve.

E63. Investors supported this provision. They expressed an expectation that the auditor would evaluate the audit committee's effectiveness and speak up if the audit committee was determined to be ineffective. Investors drew a link among restoring their confidence, audit committees having new and enhanced responsibilities, and the need for assurance that audit committees are, in fact, meeting their responsibilities.

E64. Auditors also were generally supportive of such an evaluation. However, many requested that the proposed standard be refined to clearly indicate that the auditor's responsibility to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is not a separate and distinct evaluation. Rather, the evaluation is one element of the auditor's overall understanding and assessment of the company's control environment and monitoring components. Some commenters suggested that, in addition to needing clarification of the auditor's responsibility, the auditor would have difficulty in evaluating all of the factors listed in the proposed standard, because the auditor's normal interaction with the audit committee would not provide sufficient basis to conclude on some of those factors.

E65. Issuers and some others were opposed to the auditor evaluating the effectiveness of the audit committee on the fundamental grounds that such an evaluation would represent an unacceptable conflict of interest. Several commenters shared the view that this provision would reverse an important improvement in governance and audit quality. Whereas the auditor was formerly retained and compensated by management, the Act made clear that these responsibilities should now be those of the audit committee. In this way, commenters saw a conflict of interest being remedied. Requiring the auditor to evaluate the effectiveness of the audit committee led commenters to conclude that the same kind of conflict of interest was being reestablished. These commenters also believed that the auditor would not have a sufficient basis on which to evaluate the effectiveness of the audit committee because the auditor does not have complete and free access to the audit committee, does not have appropriate expertise to evaluate audit committee members (who frequently are more experienced businesspeople than the auditor), does not have the legal expertise to make determinations about some of the specific factors listed in the proposed standard, and other shortcomings. These commenters also emphasized that the board of directors' evaluation of the audit committee is important and that the proposed standard could be read to supplant this important evaluation with that of the auditor's.

E66. The Board concluded that this provision should be retained but decided that clarification was needed to emphasize that the auditor's evaluation of the audit committee was not a separate evaluation but, rather, was made as part of the auditor's evaluation of the control environment and monitoring components of internal control over financial reporting. The Board reasoned that clarifying both this context and limitation on the auditor's evaluation of the audit committee would also address, to some degree, the conflict-of-interest concerns raised by other commenters. The Board also observed, however, that conflict is, to some extent, inherent in the duties that society expects of auditors. Just as auditors were expected in the past to challenge management when the auditor believed a material misstatement of the financial statements or material weakness in internal control over financial reporting existed, the auditor similarly is expected to speak up when he or she believes the audit committee is ineffective in its oversight.

E67. The Board decided that when the auditor is evaluating the control environment and monitoring components, if the auditor concludes that the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is ineffective, the auditor should be strongly encouraged to consider that situation a material weakness and, at a minimum, a significant deficiency. The objective of the evaluation is not to grade the effectiveness of the audit committee along a scale. Rather, in the course of performing procedures related to evaluating the effectiveness of the control environment and monitoring components, including evaluating factors related to the effectiveness of the audit committee's oversight, if the auditor concludes that the audit committee's oversight of the external financial reporting and internal control over financial reporting is ineffective, then the auditor should consider that a strong indicator of a material weakness.

E68. The Board concluded that several refinements should be made to this provision. As part of emphasizing that the auditor's evaluation of the audit committee is to be made as part of evaluating the control environment and not as a separate evaluation, the Board determined that the evaluation factors should be modified. The factors that addressed compliance with listing standards and sections of the Act were deleted, because those factors were specifically criticized in comment letters as being either outside the scope of the auditor's expertise or outside the scope of internal control over financial reporting. The Board also believed that those factors were not significant to the type of evaluation the auditor was expected to make of the audit committee. The Board decided to add the following factors, which are based closely on factors described in COSO, as relevant to evaluating those who govern, including the audit committee:

- Extent of direct and independent interaction with key members of financial management, including the chief financial officer and chief accounting officer.

- Degree to which difficult questions are raised and pursued with management and the auditor, including questions that indicate an understanding of the critical accounting policies and judgmental accounting estimates.

- Level of responsiveness to issues raised by the auditor, including those required to be communicated by the auditor to the audit committee.

E69. The Board also concluded that the standard should explicitly acknowledge that the board of directors is responsible for evaluating the effectiveness of the audit committee and that the auditor's evaluation of the control environment is not intended to supplant those evaluations. In addition, the Board concluded that, in the event the auditor determines that the audit committee's oversight is ineffective, the auditor should communicate that finding to the full board of directors. This communication should occur regardless of whether the auditor concludes that the condition represents a significant deficiency or a material weakness, and the communication should take place in addition to the normal communication requirements that attach to those deficiencies.

Definitions of Significant Deficiency and Material Weakness

E70. As part of developing the proposed standard, the Board evaluated the existing definitions of significant deficiency (which the SEC defined as being the same as a reportable condition) and material weakness to determine whether they would permit the most effective implementation of the internal control reporting requirements of the Act.

E71. AU sec. 325, *Communication of Internal Control Related Matters Noted in an Audit*, defined a material weakness as follows:

> A *material weakness* in internal control is 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.

E72. The framework that defined a material weakness focused on likelihood of and magnitude for evaluating a weakness. The Board decided that this framework would facilitate effective implementation of the Act's internal control reporting requirements; therefore, the Board's proposed definitions focused on likelihood and magnitude. However, as part of these deliberations, the Board decided that likelihood and magnitude needed to be defined in terms that would encourage more consistent application.

E73. Within the existing definition of material weakness, the magnitude of "material in relation to the financial statements" was well supported by the professional standards, SEC rules and guidance, and other literature. However, the Board decided that the definition of likelihood would be improved if it used "more than remote" instead of "relatively low level." FASB Statement No. 5, *Accounting for Contingencies* (FAS No. 5) defines "remote." The Board decided that, because auditors were familiar with the application of the likelihood definitions in FAS No. 5, using "more than remote" in the definition of material weakness would infuse the evaluation of whether a control deficiency was a material weakness with the additional consistency that the Board wanted to encourage.

E74. AU sec. 325 defined *reportable conditions* as follows:

> …matters coming to the auditor's attention that, in his judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of internal control, which could adversely affect the organization's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements.

E75. The Board observed that this definition makes the determination of whether a condition is reportable solely a matter of the auditor's judgment. The Board believed that this definition was insufficient for purposes of the Act because management also needs a definition to determine whether a deficiency is significant and that the definition should be the same as the definition used by the auditor. Furthermore, using this existing definition, the auditor's judgment could never be questioned.

E76. The Board decided that the same framework that represented an appropriate framework for defining a material weakness also should be used for defining a significant deficiency. Although auditor judgment is integral and essential to the audit process (including in determining the severity of control weaknesses), auditors, nonetheless, must be accountable for their judgments. Increasing the accountability of auditors for their judgments about whether a condition represents a significant deficiency and increasing the consistency with which those judgments are made are interrelated. Hence, the same framework of likelihood and magnitude were applied in the Board's proposed definition of significant deficiency.

E77. In applying the likelihood and magnitude framework to defining a significant deficiency, the Board decided that the "more than remote" likelihood of occurrence used in the definition of material weakness was the best benchmark. In terms of magnitude, the Board decided that "more than inconsequential" should be the threshold for a significant deficiency.

E78. A number of commenters were supportive of the definitions in the proposed standard. These commenters believed the definitions were an improvement over the previous definitions, used terms familiar to auditors, and would promote increased consistency in evaluations.

E79. Most commenters, however, objected to these definitions. The primary, over-arching objection was that these definitions set too low a threshold for the reporting of significant deficiencies. Some commenters focused on "more than remote" likelihood as the driver of an unreasonably low threshold, while others believed "more than inconsequential" in the definition of significant deficiency was the main culprit. While some commenters understood "more than inconsequential" well enough, others indicated significant concerns that this represented a new term of art that needed to be accompanied by a clear definition of "inconsequential" as well as supporting examples. Several commenters suggested retaining the likelihood and magnitude approach to a definition but suggested alternatives for likelihood (such as reasonably likely, reasonably possible, more likely than not, probable) and magnitude (such as material, significant, insignificant).

E80. Some commenters suggested that the auditing standard retain the existing definitions of material weakness and significant deficiency, consistent with the SEC's final rules implementing Section 404. In their final rules, the SEC tied management's assessment to the existing definitions of material weakness and significant deficiency (through the existing definition of a reportable condition) in AU sec. 325. These commenters suggested that, if the auditing standard used a different definition, a dangerous disconnect would result, whereby management would be using one set of definitions under the SEC's rules and auditors would be using another set under the Board's auditing standards. They further suggested that, absent rulemaking by the SEC to change its definitions, the Board should simply defer to the existing definitions.

E81. A number of other commenters questioned the reference to "a misstatement of the annual or interim financial statements" in the definitions, with the emphasis on why "interim" financial statements were included in the definition, since Section 404 required only an annual assessment of internal control over financial reporting effectiveness, made as of year-end. They questioned whether this definition implied that the auditor was required to identify deficiencies that could result in a misstatement in interim financial statements; they did not believe that the auditor should be required to plan his or her audit of internal control over financial reporting at a materiality level of the interim financial statements.

E82. The Board ultimately concluded that focusing the definitions of material weakness and significant deficiency on likelihood of misstatement and magnitude of misstatement provides the best framework for evaluating deficiencies. Defaulting to the existing definitions would not best serve the public interest nor facilitate meaningful and effective implementation of the auditing standard.

E83. The Board observed that the SEC's final rules requiring management to report on internal control over financial reporting define material weakness, for the purposes of the final rules, as having "the same meaning as the definition under GAAS and attestation standards." Those rules state:

> The term "significant deficiency" has the same meaning as the term "reportable condition" as used in AU §325 and AT§501. The terms "material weakness" and "significant deficiency" both represent

deficiencies in the design or operation of internal control that could adversely affect a company's ability to record, process, summarize and report financial data consistent with the assertions of management in the company's financial statements, with a "material weakness" constituting a greater deficiency than a "significant deficiency." Because of this relationship, it is our judgment that an aggregation of significant deficiencies could constitute a material weakness in a company's internal control over financial reporting.[42/]

E84. The Board considered the SEC's choice to cross-reference to generally accepted auditing standards (GAAS) and the attestation standards as the means of defining these terms, rather than defining them outright within the final rules, noteworthy as it relates to the question of whether any disconnect could result between auditors' and managements' evaluations if the Board changed the definitions in its standards. Because the standard changes the definition of these terms within the interim standards, the Board believes the definitions are, therefore, changed for both auditors' and managements' purposes.

E85. The Board noted that commenters who were concerned that the definitions in the proposed standard set too low of a threshold for significant deficiencies and material weaknesses believed that the proposed standard required that each control deficiency be evaluated in isolation. The intent of the proposed standard was that control deficiencies should first be evaluated individually; the determination as to whether they are significant deficiencies or material weaknesses should be made considering the effects of compensating controls. The effect of compensating controls should be taken into account when assessing the likelihood of a misstatement occurring and not being prevented or detected. The proposed standard illustrated this type of evaluation, including the effect of compensating controls when assessing likelihood, in the examples in Appendix D. Based on the comments received, however, the Board determined that additional clarification within the standard was necessary to emphasize the importance of considering compensating controls when evaluating the likelihood of a misstatement occurring. As a result, the note to paragraph 10 was added.

E86. The Board concluded that considering the effect of compensating controls on the likelihood of a misstatement occurring and not being prevented or detected sufficiently addressed the concerns that the definitions set too low a threshold. For example, several issuer commenters cited concerns that the proposed definitions precluded a rational cost-benefit analysis of whether to correct a deficiency. These issuers believed they would be compelled to correct deficiencies (because the deficiencies would be considered to be at least significant deficiencies) in situations in which management had made a previous

[42/] See footnote 73 to *Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports,* Securities and Exchange Commission Release No. 33-8238 (June 5, 2003) [68 FR 36636].

conscious decision that the costs of correcting the deficiency outweighed the benefits. The Board observed that, in cases in which management has determined not to correct a known deficiency based on a cost-benefit analysis, effective compensating controls usually lie at the heart of management's decision. The standard's use of "likelihood" in the definition of a significant deficiency or material weakness accommodates such a consideration of compensating controls. If a deficiency is effectively mitigated by compensating controls, then the likelihood of a misstatement occurring and not being prevented or detected may very well be remote.

E87. The Board disagreed with comments that "more than inconsequential" was too low a threshold; however, the Board decided the term "inconsequential" needed additional clarity. The Board considered the term "inconsequential" in relation to the SEC's guidance on audit requirements and materiality. Section 10A(b)(1)(B)[43/] describes the auditor's communication requirements when the auditor detects or otherwise becomes aware of information indicating that an illegal act has or may have occurred, "unless the illegal act is clearly inconsequential." Staff Accounting Bulletin (SAB) No. 99, *Materiality*, provides the most recent and definitive guidance on the concept of materiality as it relates to the financial reporting of a public company. SAB No. 99 uses the term "inconsequential" in several places to draw a distinction between amounts that are not material. SAB No. 99 provides the following guidance to assess the significance of a misstatement:

> Though the staff does not believe that registrants need to make finely calibrated determinations of significance with respect to immaterial items, plainly it is "reasonable" to treat misstatements whose effects are clearly inconsequential differently than more significant ones.

E88. The discussion in the previous paragraphs provided the Board's context for using "material" and "more than inconsequential" for the magnitude thresholds in the standard's definitions. "More than inconsequential" indicates an amount that is less than material yet has significance.

E89. The Board also considered the existing guidance in the Board's interim standards for evaluating materiality and accumulating audit differences in a financial statement audit. Paragraph .41 of AU sec. 312, *Audit Risk and Materiality in Conducting an Audit,* states:

> In aggregating likely misstatements that the entity has not corrected, pursuant to paragraphs .34 and .35, the auditor may designate an amount below which misstatements need not be accumulated. This amount should be set so that any such misstatements, either individually or when aggregated with other such misstatements, would not be material to the

[43/] See Section 10A of the Securities Exchange Act of 1934, 15 U.S.C., 78j-1.

financial statements, after the possibility of further undetected misstatements is considered.

E90. The Board considered the discussion in AU sec. 312 that spoke specifically to evaluating differences individually *and in the aggregate*, as well as to considering the possibility of additional undetected misstatements, important distinguishing factors that should be carried through to the evaluation of whether a control deficiency represents a significant deficiency because the magnitude of the potential misstatement is more than inconsequential.

E91. The Board combined its understanding of the salient concepts in AU sec. 312 and the SEC guidance on materiality to develop the following definition of inconsequential:

> A misstatement is *inconsequential* if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, either individually or when aggregated with other misstatements, would clearly be immaterial to the financial statements. If a reasonable person could not reach such a conclusion regarding a particular misstatement, that misstatement is *more than inconsequential.*

E92. Finally, the inclusion of *annual or interim financial statements* in the definitions rather than just "annual financial statements" was intentional and, in the Board's opinion, closely aligned with the spirit of what Section 404 seeks to accomplish. However, the Board decided that this choice needed clarification within the auditing standard. The Board did not intend the inclusion of the interim financial statements in the definition to require the auditor to perform *an audit of internal control over financial reporting* at each interim date. Rather, the Board believed that the SEC's definition of internal control over financial reporting included all financial reporting that a public company makes publicly available. In other words, internal control over financial reporting includes controls over the preparation of annual and quarterly financial statements. Thus, an evaluation of internal control over financial reporting as of year-end encompasses controls over the annual financial reporting and quarterly financial reporting as such controls exist at that point in time.

E93. Paragraphs 76 and 77 of the standard clarify this interpretation, as part of the discussion of the period-end financial reporting process. The period-end financial reporting process includes procedures to prepare both annual and quarterly financial statements.

Strong Indicators of Material Weaknesses and DeFacto Significant Deficiencies

E94. The proposed standard identified a number of circumstances that, because of their likely significant negative effect on internal control over financial reporting, are significant deficiencies as well as strong indicators that a material weakness exists. The Board developed this list to promote increased rigor and consistency in auditors' evaluations of weaknesses. For the implementation of Section 404 of the Act to achieve its objectives, the public must have confidence that all material weaknesses that exist as of the company's year-end will be publicly reported. Historically, relatively few material weaknesses have been reported by the auditor to management and the audit committee. That condition is partly due to the nature of a financial statement audit. In an audit of only the financial statements, the auditor does not have a detection responsibility for material weaknesses in internal control; such a detection responsibility is being newly introduced for all public companies through Sections 103 and 404 of the Act. However, the Board was concerned about instances in which auditors had identified a condition that should have been, but was not, communicated as a material weakness. The intention of including the list of strong indicators of material weaknesses in the proposed standard was to bring further clarity to conditions that were likely to be material weaknesses in internal control and to create more consistency in auditors' evaluations.

E95. Most commenters were generally supportive of a list of significant deficiencies and strong indicators of the existence of material weaknesses. They believed such a list provided instructive guidance to both management and the auditor. Some commenters, however, disagreed with the proposed approach of providing such a list. They believed that the determination of the significance of a deficiency should be left entirely to auditor judgment. A few commenters requested clarification of the term "strong indicator" and specific guidance on how and when a "strong indicator" could be overcome. A number of commenters expressed various concerns with individual circumstances included in the list.

- *Restatement of previously issued financial statements to reflect the correction of a misstatement*. Some commenters expressed concern about the kinds of restatements that would trigger this provision. A few mentioned the specific instance in which the restatement reflected the SEC's subsequent view of an accounting matter when the auditor, upon reevaluation, continued to believe that management had reasonable support for its original position. They believed this specific circumstance would not necessarily indicate a significant deficiency in internal control over financial reporting. Others commented that a restatement of previously issued financial statements would indicate a significant deficiency and strong indicator of a material weakness *in the prior period* but not necessarily in the current period.

- *Identification by the auditor of a material misstatement in financial statements in the current period that was not initially identified by the company's internal control over financial reporting (even if management subsequently corrects the misstatement)*. Several commenters, issuers and auditors alike, expressed concern about including this circumstance on the list. They explained that, frequently, management is completing the preparation of the financial statements at the same time that the auditor is completing his or her auditing procedures. In the face of this "strong indicator" provision, a lively debate of "who found it first" would ensue whenever the auditor identifies a misstatement that management subsequently corrects. Another argument is that the company's controls would have detected a misstatement identified by the auditor if the controls had an opportunity to operate (that is, the auditor performed his or her testing before the company's controls had an opportunity to operate). Several issuers indicated that they would prevent this latter situation by delaying the auditor's work until the issuers had clearly completed their entire period-end financial reporting process – a delay they viewed as detrimental.

- *For larger, more complex entities, the internal audit function or the risk assessment function is ineffective*. Several commenters asked for specific factors the auditor was expected to use to assess the effectiveness of these functions.

- *For complex entities in highly regulated industries, an ineffective regulatory compliance function.* Several commenters, particularly issuers in highly regulated industries, objected to the inclusion of this circumstance because they believed this to be outside the scope of internal control over financial reporting. (They agreed that this would be an internal control-related matter, but one that falls into operating effectiveness and compliance with laws and regulations, not financial reporting.) Many of these commenters suggested that this circumstance be deleted from the list altogether. Fewer commenters suggested that this problem could be addressed by simply clarifying that this circumstance is limited to situations in which the ineffective regulatory function relates solely to those aspects for which related violations of laws and regulations could have a direct and material effect on the financial statements.

- *Identification of fraud of any magnitude on the part of senior management*. Several commenters expressed concern that the inclusion of this circumstance created a detection responsibility for the auditor such that the auditor would have to plan and perform procedures to detect fraud *of any magnitude* on the part of senior management. Others expressed concern that identification of fraud on the part of senior management by the company's system of internal control over financial reporting might indicate that controls were operating effectively rather than indicating a significant deficiency or material weakness. Still others requested clarification on how to determine who constituted "senior management."

E96. A couple of commenters also suggested that an ineffective control environment should be added to the list.

E97. The Board concluded that the list of significant deficiencies and strong indicators of material weakness should be retained. Such a list will promote consistency in auditors' and managements' evaluations of deficiencies consistent with the definitions of significant deficiency and material weakness. The Board also decided to retain the existing structure of the list. Although the standard leaves auditor judgment to determine whether those deficiencies are material weaknesses, the existence of one of the listed deficiencies is by definition a significant deficiency. Furthermore, the "strong indicator" construct allows the auditor to factor extenuating or unique circumstances into the evaluation and possibly to conclude that the situation does not represent a material weakness, rather, only a significant deficiency.

E98. The Board decided that further clarification was not necessary within the standard itself addressing specifically how and when a "strong indicator" can be overcome. The term "strong indicator" was selected as opposed to the stronger "presumption" or other such term precisely because the Board did not intend to provide detailed instruction on how to overcome such a presumption. It is, nevertheless, the Board's view that auditors should be biased toward considering the listed circumstances as material weaknesses.

E99. The Board decided to clarify several circumstances included in the list:

- *Restatement of previously issued financial statements to reflect the correction of a misstatement*. The Board observed that the circumstance in which a restatement reflected the SEC's subsequent view of an accounting matter, when the auditor concluded that management had reasonable support for its original position, might present a good example of only a significant deficiency and not a material weakness. However, the Board concluded that requiring this situation to, nonetheless, be considered by definition a significant deficiency is appropriate, especially considering that the primary result of the circumstance being considered a significant deficiency is the communication of the matter to the audit committee. Although the audit committee might already be well aware of the circumstances of any restatement, a restatement to reflect the SEC's view on an accounting matter at least has implications for the quality of the company's accounting principles, which is already a required communication to the audit committee.

  With regard to a restatement being a strong indicator of a material weakness in the prior period but not necessarily the current period, the Board disagreed with these comments. By virtue of the restatement occurring during the current period, the Board views it as appropriate to consider that circumstance a strong indicator that a material weakness existed during the current period. Depending on the circumstances of the restatement, however, the material weakness may also have been corrected during the current period. The construct of the standard does not preclude management and the auditor from determining that the circumstance was corrected prior to year-end and, therefore, that a material weakness did not exist at year-end. The emphasis here is that the circumstance is a strong indicator that a material weakness exists; management and the auditor will separately need to determine whether it has been corrected. The Board decided that no further clarification was needed in this regard.

- *Identification by the auditor of a material misstatement in financial statements in the current period that was not initially identified by the company's internal control over financial reporting (even if management subsequently corrects the misstatement)*. Regarding the "who-found-it-first" dilemma, the Board recognizes that this circumstance will present certain implementation challenges. However, the Board decided that none of those challenges were so significant as to require eliminating this circumstance from the list.

  When the Board developed the list of strong indicators, the Board observed that it is not uncommon for the financial statement auditor to identify material misstatements in the course of the audit that are corrected by management prior to the issuance of the company's financial statements. In some cases, management has relied on the auditor to identify misstatements in certain financial statement items and to propose corrections in amount, classification, or disclosure. With the introduction of the requirement for management and the auditor to report on the effectiveness of internal control over financial reporting, it becomes obvious that this situation is unacceptable, unless management is willing to accept other than an unqualified report on the internal control effectiveness. (This situation also raises the question as to the extent management may rely on the annual audit to produce accurate and fair financial statements without impairing the auditor's independence.) This situation is included on the list of strong indicators because the Board believes it will encourage management and auditors to evaluate this situation with intellectual honesty and to recognize, first, that the company's internal control should provide reasonable assurance that the company's financial statements are presented fairly in accordance with generally accepted accounting principles.

  Timing might be a concern for some issuers. However, to the extent that management takes additional steps to ensure that the financial information is correct prior to providing it to their auditors, this may, at times, result in an improved control environment. When companies and auditors work almost simultaneously on completing the preparation of the annual financial statements and the audit, respectively, the role of the auditor can blur with the responsibility of management. In the year-end rush to complete the annual report, some companies might have come to rely on their auditors as a "control" to further ensure no misstatements are accidentally reflected in the financial statements. The principal burden seems to be for management's work schedule and administration of their financial reporting deadlines to allow the auditor sufficient time to complete his or her procedures.

Further, if the auditor initially identified a material misstatement in the financial statements but, given the circumstances, determined that management ultimately would have found the misstatement, the auditor could determine that the circumstance was a significant deficiency but not a material weakness. The Board decided to retain the provision that this circumstance is at least a significant deficiency because reporting such a circumstance to the audit committee would always be appropriate.

- *For larger, more complex entities, the internal audit function or the risk assessment function is ineffective*. Relatively few commenters requested clarification on how to evaluate these functions. The Board expects that most auditors will not have trouble making this evaluation. Similar to the audit committee evaluation, this evaluation is not a separate evaluation of the internal audit or risk assessment functions but, rather, is a way of requiring the auditor to speak up if either of these functions is obviously ineffective at an entity that needs them to have an effective monitoring or risk assessment component. Unlike the audit committee discussion, most commenters seemed to have understood that this was the context for the internal audit and risk assessment function evaluation. Nonetheless, the Board decided to add a clarifying note to this circumstance emphasizing the context.

- *For complex entities in highly regulated industries, an ineffective regulatory compliance function*. The Board decided that this circumstance, as described in the proposed standard, would encompass aspects that are outside internal control over financial reporting (which would, of course, be inappropriate for purposes of this standard given its definition of internal control over financial reporting). The Board concluded that this circumstance should be retained, though clarified, to only apply to those aspects of an ineffective regulatory compliance function that could have a material effect on the financial statements.

- *Identification of fraud of any magnitude on the part of senior management.* The Board did not intend to create any additional detection responsibility for the auditor; rather, it intended that this circumstance apply to fraud on the part of senior management that came to the auditor's attention, regardless of amount. The Board decided to clarify the standard to make this clear. The Board noted that identification of fraud by the company's system of internal control over financial reporting might indicate that controls were operating effectively, except when that fraud involves senior management. Because of the critical role of tone-at-the-top in the overall effectiveness of the control environment and due to the significant negative evidence that fraud of any magnitude on the part of senior management reflects on the control environment, the Board decided that it is appropriate to include this circumstance in the list, regardless of whether the company's controls detected the fraud. The Board also decided to clarify who is included in "senior management" for this purpose.

E100. The Board agreed that an ineffective control environment was a significant deficiency and a strong indicator that a material weakness exists and decided to add it to the list.

Independence

E101. The proposed standard explicitly prohibited the auditor from accepting an engagement to provide an internal control-related service to an audit client that has not been specifically pre-approved by the audit committee. In other words, the audit committee would not be able to pre-approve internal control-related services as a category. The Board did not propose any specific guidance on permissible internal control-related services in the proposed standard but, rather, indicated its intent to conduct an in-depth evaluation of independence requirements in the future and highlighted its ability to amend the independence information included in the standard pending the outcome of that analysis.

E102. Comments were evenly split among investors, auditors, and issuers who believed the existing guidance was sufficient versus those who believed the Board should provide additional guidance. Commenters who believed existing guidance was sufficient indicated that the SEC's latest guidance on independence needed to be given more time to take effect given its recency and because existing guidance was clear enough. Commenters who believed more guidance was necessary suggested various additions, from more specificity about permitted and prohibited services to a sweeping ban on any internal control-related work for an audit client. Other issuers commented about auditors participating in the Section 404 implementation process at their audit clients in a manner that could be perceived as affecting their independence.

E103. Some commenters suggested that the SEC should change the pre-approval requirements on internal control-related services to specific pre-approval. Another commenter suggested that specific pre-approval of all internal control-related services would pose an unreasonable burden on the audit committee and suggested reverting to pre-approval by category.

E104. The Board clearly has the authority to set independence standards as it may deem necessary or appropriate in the public interest or for the protection of investors. Given ongoing concerns about the appropriateness of auditors providing these types of services to audit clients, the fact-specific nature of each engagement, and the critical importance of ongoing audit committee oversight of these types of services, the Board continues to believe that specific pre-approval of internal control-related services is a logical step that should not pose a burden on the audit committee beyond that which effective oversight of financial reporting already entails. Therefore, the standard retains this provision unchanged.

Requirement for Adverse Opinion When a Material Weakness Exists

E105. The existing attestation standard (AT sec. 501) provides that, when the auditor has identified a material weakness in internal control over financial reporting, depending on the significance of the material weakness and its effect on the achievement of the objectives of the control criteria, the auditor may qualify his or her opinion ("except for the effect of the material weakness, internal control over financial reporting was effective") or express an adverse opinion ("internal control over financial reporting was not effective").

E106. The SEC's final rules implementing Section 404 state that, "Management is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting." In other words, in such a case, management must conclude that internal control over financial reporting is not effective (that is, a qualified or "except-for" conclusion is not acceptable).

E107. The Board initially decided that the reporting model for the auditor should follow the required reporting model for management. Therefore, because management is required to express an "adverse" conclusion in the event a material weakness exists, the auditor's opinion also must be adverse. The proposed standard did not permit a qualified audit opinion in the event of a material weakness.

E108. Comments received on requiring an adverse opinion when a material weakness exists were split. A large number affirmed that this seemed to be the only logical approach, based on a philosophical belief that if a material weakness exists, then internal control over financial reporting is ineffective. These commenters suggested that permitting a qualified opinion would be akin to creating another category of control deficiency—material weaknesses that were really material (resulting in an adverse opinion) and material weaknesses that weren't so material (resulting in a qualified opinion).

E109. A number of commenters agreed that the auditor's report must follow the same model as management' reporting, but they believe strongly that the SEC's guidance for management accommodated either a qualified or adverse opinion when a material weakness existed.

E110. These commenters cited Section II.B.3.c of the SEC Final Rule and related footnote no. 72:

> The final rules therefore preclude management from determining that a company's internal control over financial reporting is effective if it identifies one or more material weaknesses in the company's

> internal control over financial reporting. This is consistent with interim attestation standards. See AT sec. 501.

E111. They believe this reference to the interim attestation standard in the SEC Final Rule is referring to paragraph .37 of AT sec. 501, which states, in part,

> Therefore, the presence of a material weakness will preclude the practitioner from concluding that the entity has effective internal control. However, depending on the significance of the material weakness and its effect on the achievement of the objectives of the control criteria, the practitioner may qualify his or her opinion (that is, express an opinion that internal control is effective "except for" the material weakness noted) or may express an adverse opinion.

E112. Their reading of the SEC Final Rule and the interim attestation standard led them to conclude that it would be appropriate for the auditor to express either an adverse opinion or a qualified "except-for" opinion about the effectiveness of the company's internal control over financial reporting depending on the circumstances.

E113. Some commenters responded that they thought a qualified opinion would be appropriate in certain cases, such as an acquisition close to year-end (too close to be able to assess controls at the acquiree).

E114. After additional consultation with the SEC staff about this issue, the Board decided to retain the proposed reporting model in the standard. The primary reason for that decision was the Board's continued understanding that the SEC staff would expect only an adverse conclusion from management (not a qualified conclusion) in the event a material weakness existed as of the date of management's report.

E115. The commenters who suggested that a qualified opinion should be permitted in certain circumstances, such as an acquisition close to year-end, were essentially describing scope limitations. The standard permits a qualified opinion, a disclaimer of opinion, or withdrawal from the engagement if there are restrictions on the scope of the engagement. As it relates specifically to acquisitions near year-end, this is another case in which the auditor's model needs to follow the model that the SEC sets for management. The standard added a new paragraph to Appendix B permitting the auditor to limit the scope of his or her work (without referring to a scope limitation in the auditor's report) in the same manner that the SEC permits management to limit its assessment. In other words, if the SEC permits management to exclude an entity acquired late in the year from a company's assessment of internal control over financial reporting, then the auditor could do the same.

Rotating Tests of Controls

E116. The proposed standard directed the auditor to perform tests of controls on "relevant assertions" rather than on "significant controls." To comply with those requirements, the auditor would be required to apply tests to those controls that are important to presenting each relevant assertion in the financial statements. The proposed standard emphasized controls that affect relevant assertions because those are the points at which misstatements could occur. However, it is neither necessary to test all controls nor to test redundant controls (unless redundancy is itself a control objective, as in the case of certain computer controls). Thus, the proposed standard encouraged the auditor to identify and test controls that addressed the primary areas in which misstatements could occur, yet limited the auditor's work to only the necessary controls.

E117. Expressing the extent of testing in this manner also simplified other issues involving extent of testing decisions from year to year (the so-called "rotating tests of controls" issue). The proposed standard stated that the auditor should vary testing from year to year, both to introduce unpredictability into the testing and to respond to changes at the company. However, the proposed standard maintained that each year's audit must stand on its own. Therefore, the auditor must obtain evidence of the effectiveness of controls over all relevant assertions related to all significant accounts and disclosures every year.

E118. Auditors and investors expressed support for these provisions as described in the proposed standard. In fact, some commenters compared the notion of rotating tests of control in an audit of internal control over financial reporting to an auditor testing accounts receivable only once every few years in a financial statement audit. Permitting so-called rotation of testing would compromise the auditor's ability to obtain reasonable assurance that his or her opinion was correct.

E119. Others, especially issuers concerned with limiting costs, strongly advocated some form of rotating tests of controls. Some commenters suggested that the auditor should have broad latitude to perform some cursory procedures to determine whether any changes had occurred in controls and, if not, to curtail any further testing in that area. Some suggested that testing as described in the proposed standard should be required in the first year of the audit (the "baseline" year) and that in subsequent years the auditor should be able to reduce the required testing. Others suggested progressively less aggressive strategies for reducing the amount of work the auditor should be required to perform. In fact, several commenters (primarily internal auditors) described "baselining" controls as an important strategy to retain. They argued, for example, that IT application controls, once tested, could be relied upon (without additional testing) in subsequent years as long as general controls over program changes and access controls were effective and continued to be tested.

E120. The Board concluded that each year's audit must stand on its own. Cumulative audit knowledge is not to be ignored; some natural efficiencies will emerge as the auditor repeats the audit process. For example, the auditor will frequently spend less time to obtain the requisite understanding of the company's internal control over financial reporting in subsequent years compared with the time necessary in the first year's audit of internal control over financial reporting. Also, to the extent that the auditor has previous knowledge of control weaknesses, his or her audit strategy should, of course, reflect that knowledge. For example, a pattern of mistakes in prior periods is usually a good indicator of the areas in which misstatements are likely to occur. However, the absence of fraud in prior periods is not a reasonable indicator of the likelihood of misstatement due to fraud.

E121. However, the auditor needs to test controls every year, regardless of whether controls have obviously changed. Even if nothing else changed about the company – no changes in the business model, employees, organization, etc. – controls that were effective last year may not be effective this year due to error, complacency, distraction, and other human conditions that result in the inherent limitations in internal control over financial reporting.

E122. What several commenters referred to as "baselining" (especially as it relates to IT controls) is more commonly referred to by auditors as "benchmarking." This type of testing strategy for application controls is not precluded by the standard. However, the Board believes that providing a description of this approach is beyond the scope of this standard. For these reasons, the standard does not address it.

Mandatory Integration with the Audit of the Financial Statements

E123. Section 404(b) of the Act provides that the auditor's attestation of management's assessment of internal control shall not be the subject of a separate engagement. Because the objectives of and work involved in performing both an attestation of management's assessment of internal control over financial reporting and an audit of the financial statements are closely interrelated, the proposed auditing standard introduced an integrated audit of internal control over financial reporting and audit of financial statements.

E124. However, the proposed standard went even further. Because of the potential significance of the information obtained during the audit of the financial statements to the auditor's conclusions about the effectiveness of internal control over financial reporting, the proposed standard stated that the auditor could not audit internal control over financial reporting without also auditing the financial statements. (However, the proposed standard retained the auditor's ability to audit *only* the financial statements, which might be necessary in the case of certain initial public offerings.)

E125. Although the Board solicited specific comment on whether the auditor should be prohibited from performing an audit of internal control over financial reporting without also performing an audit of the financial statements, few commenters focused on the significance of the potentially negative evidence that would be obtained during the audit of the financial statements or the implications of this prohibition. Most commenters focused on the wording of Section 404(b), which indicates that the auditor's attestation of management's assessment of internal control over financial reporting shall not be the subject of a separate engagement. Based on this information, most commenters saw the prohibition in the proposed standard as superfluous and benign.

E126. Several commenters recognized the importance of the potentially negative evidence that might be obtained as part of the audit of the financial statements and expressed strong support for requiring that an audit of financial statements be performed to audit internal control over financial reporting.

E127. Others recognized the implications of this prohibition and expressed concern: What if a company wanted or needed an opinion on the effectiveness of internal control over financial reporting as of an interim date? For the most part, these commenters (primarily issuers) objected to the implication that an auditor would have to audit a company's financial statements as of an interim date to enable him or her to audit and report on its internal control over financial reporting as of that same interim date. Other issuers expressed objections related to their desires to engage one auditor to provide an opinion on the effectiveness of internal control over financial reporting and another to audit the financial statements. Others requested clarification about which guidance would apply when other forms of internal control work were requested by companies.

E128. The Board concluded that an auditor should perform an audit of internal control over financial reporting only when he or she has also audited company's financial statements. The auditor *must* audit the financial statements to have a high level of assurance that his or her conclusion on the effectiveness of internal control over financial reporting is correct. Inherent in the reasonable assurance provided by the auditor's opinion on internal control over financial reporting is a responsibility for the auditor to plan and perform his or her work to obtain reasonable assurance that material weaknesses, if they exist, are detected. As previously discussed, this standard states that the identification by the auditor of a *material misstatement* in the financial statements that was not initially identified by the company's internal control over financial reporting, is a strong indicator of a material weakness. Without performing a financial statement audit, the auditor would not have reasonable assurance that he or she had detected all material misstatements. The Board believes that allowing the auditor to audit internal control over financial reporting without also auditing the financial statements would not provide the auditor with a high level of assurance and would mislead investors in terms of the level of assurance obtained.

E129. In response to other concerns, the Board noted that an auditor can report on the effectiveness of internal control over financial reporting using existing AT sec. 501 for purposes other than satisfying the requirements of Section 404. This standard supersedes AT sec. 501 only as it relates to complying with Section 404 of the Act.

E130. Although reporting under the remaining provisions of AT sec. 501 is currently permissible, the Board believes reports issued for public companies under the remaining provisions of AT sec. 501 will be infrequent. In any event, additional rulemaking might be necessary to prevent confusion that might arise from reporting on internal control engagements under two different standards. For example, explanatory language could be added to reports issued under AT sec. 501 to clarify that an audit of financial statements was not performed in conjunction with the attestation on internal control over financial reporting and that such a report is not the report resulting from an audit of internal control over financial reporting performed in conjunction with an audit of the financial statements under this standard. This report modification would alert report readers, particularly if such a report were to appear in an SEC filing or otherwise be made publicly available, that the assurance obtained by the auditor in that engagement is different from the assurance that would have been obtained by the auditor for Section 404 purposes. Another example of the type of change that might be necessary in separate rulemaking to AT sec. 501 would be to supplement the performance directions to be comparable to those in this standard. Auditors should remain alert for additional rulemaking by the Board that affects AT sec. 501.

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-   ; File No. PCAOB-2004-03)

[Date]

Public Company Accounting Oversight Board; Notice of Filing of Proposed Rule on Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*

Pursuant to Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), notice is hereby given that on March 18, 2004, the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") filed with the Securities and Exchange Commission (the "Commission") the proposed rule described in Items I, II, and III below, which items have been prepared by the Board. The Commission is publishing this notice to solicit comments on the proposed rule from interested persons.

I. Board's Statement of the Terms of Substance of the Proposed Rule

On March 9, 2004, the Board adopted a rule, Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (“the proposed rule”). The proposed rule text is set out below.

II. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule

In its filing with the Commission, the Board included statements concerning the purpose of, and basis for, the proposed rule and discussed any comments it received on the proposed rule. The text of these statements may be examined at the places specified in Item IV below. The Board has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Board's Statement of the Purpose Of, and Statutory Basis for, the Proposed Rule

(a) Purpose

Section 103(a)(1) of the Act authorized the PCAOB to establish, by rule, auditing standards to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by the Act. PCAOB Rule 3100, "Compliance with Auditing and Related Professional Practice Standards," requires auditors to comply with all applicable auditing and related professional practice standards established by the PCAOB. The text of the proposed rule, including an appendix of illustrative auditor's reports, is set out below.

Auditing Standard No. 2 – *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*

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Applicability of Standard

1. This standard establishes requirements and provides directions that apply when an auditor is engaged to audit both a company's financial statements and management's assessment of the effectiveness of internal control over financial reporting.

> Note: The term *auditor* includes both public accounting firms registered with the Public Company Accounting Oversight Board ("PCAOB" or the "Board") and associated persons thereof.

2. A company subject to the reporting requirements of the Securities Exchange Act of 1934 (an "issuer") is required to include in its annual report a report of management on the company's internal control over financial reporting. Registered investment companies, issuers of asset-backed securities, and nonpublic companies are not subject to the reporting requirements mandated by Section 404 of the Sarbanes-Oxley Act of 2002 (the "Act") (PL 107-204). The report of management is required to contain management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including a statement as to whether the company's internal control over financial reporting is effective. The auditor that audits the company's financial statements included in the annual report is required to attest to and report on management's assessment. The company is required to file the auditor's attestation report as part of the annual report.

> Note: The term issuer means an issuer (as defined in Section 3 of the Securities Exchange Act of 1934), the securities of which are registered under Section 12 of that Act, or that is required to file reports under Section 15(d) of that Act, or that files or has filed a registration statement with the Securities and Exchange Commission ("SEC" or "Commission") that has not yet become effective under the Securities Act of 1933, and that it has not withdrawn.

> Note: Various parts of this standard summarize legal requirements imposed on issuers by the SEC, as well as legal requirements imposed on auditors by regulatory authorities other than the PCAOB. These parts of

the standard are intended to provide context and to promote the auditor's understanding of the relationship between his or her obligations under this standard and his or her other legal responsibilities. The standard does not incorporate these legal requirements by reference and is not an interpretation of those other requirements and should not be so construed. (This Note does not apply to references in the standard to the existing professional standards and the Board's interim auditing and related professional practice standards.)

3. This standard is the standard on attestation engagements referred to in Section 404(b) of the Act. This standard is also the standard referred to in Section 103(a)(2)(A)(iii) of the Act. Throughout this standard, the auditor's attestation of management's assessment of the effectiveness of internal control over financial reporting required by Section 404(b) of the Act is referred to as the *audit of internal control over financial reporting*.

Note: The two terms *audit of internal control over financial reporting* and *attestation of management's assessment of the effectiveness of internal control over financial reporting* refer to the same professional service. The first refers to the process, and the second refers to the result of that process.

Auditor's Objective in an Audit of Internal Control Over Financial Reporting

4. The auditor's objective in an audit of internal control over financial reporting is to express an opinion on management's assessment of the effectiveness of the company's internal control over financial reporting. To form a basis for expressing such an opinion, the auditor must plan and perform the audit to obtain reasonable assurance about whether the company maintained, in all material respects, effective internal control over financial reporting as of the date specified in management's assessment. The auditor also must audit the company's financial statements as of the date specified in management's assessment because the information the auditor obtains during a financial statement audit is relevant to the auditor's conclusion about the effectiveness of the company's internal control over financial reporting. Maintaining effective internal control over financial reporting means that no material weaknesses exist; therefore, the objective of the audit of internal control over financial reporting is to obtain reasonable assurance that no material weaknesses exist as of the date specified in management's assessment.

5. To obtain reasonable assurance, the auditor evaluates the assessment performed by management and obtains and evaluates evidence about whether the internal control over financial reporting was designed and operated effectively. The auditor obtains this evidence from a number of sources,

including using the work performed by others and performing auditing procedures himself or herself.

6. The auditor should be aware that persons who rely on the information concerning internal control over financial reporting include investors, creditors, the board of directors and audit committee, and regulators in specialized industries, such as banking or insurance. The auditor should be aware that external users of financial statements are interested in information on internal control over financial reporting because it enhances the quality of financial reporting and increases their confidence in financial information, including financial information issued between annual reports, such as quarterly information. Information on internal control over financial reporting is also intended to provide an early warning to those inside and outside the company who are in a position to insist on improvements in internal control over financial reporting, such as the audit committee and regulators in specialized industries. Additionally, Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a),[1/] whichever applies, require management, with the participation of the principal executive and financial officers, to make quarterly and annual certifications with respect to the company's internal control over financial reporting.

Definitions Related to Internal Control Over Financial Reporting

7. For purposes of management's assessment and the audit of internal control over financial reporting in this standard, *internal control over financial reporting* is defined as follows:

> A process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:
>
> (1) Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;
>
> (2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that

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[1/] See 17 C.F.R. 240.13a-14(a) or 17 C.F.R. 240.15d-14(a), whichever applies.

receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Note: This definition is the same one used by the SEC in its rules requiring management to report on internal control over financial reporting, except the word "registrant" has been changed to "company" to conform to the wording in this standard. (See Securities Exchange Act Rules 13a-15(f) and 15d-15(f).[2/])

Note: Throughout this standard, *internal control over financial reporting* (singular) refers to the process described in this paragraph. Individual controls or subsets of controls are referred to as *controls* or *controls over financial reporting*.

8. A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

- A deficiency in *design* exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective is not always met.

- A deficiency in *operation* exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively.

9. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected.

Note: The term "remote likelihood" as used in the definitions of *significant deficiency* and *material weakness* (paragraph 10) has the same meaning as the term "remote" as used in Financial Accounting Standards Board

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[2/] See 17 C.F.R. 240, 13a-15(f) and 15d-15(f).

Statement No. 5, *Accounting for Contingencies* ("FAS No. 5"). Paragraph 3 of FAS No. 5 states:

> When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms *probable*, *reasonably possible*, and *remote* to identify three areas within that range, as follows:
>
> a. *Probable*. The future event or events are likely to occur.
> b. *Reasonably possible*. The chance of the future event or events occurring is more than remote but less than likely.
> c. *Remote*. The chance of the future events or events occurring is slight.

Therefore, the likelihood of an event is "more than remote" when it is either reasonably possible or probable.

Note: A misstatement is *inconsequential* if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, either individually or when aggregated with other misstatements, would clearly be immaterial to the financial statements. If a reasonable person could not reach such a conclusion regarding a particular misstatement, that misstatement is *more than inconsequential*.

10. A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

Note: In evaluating whether a control deficiency exists and whether control deficiencies, either individually or in combination with other control deficiencies, are significant deficiencies or material weaknesses, the auditor should consider the definitions in paragraphs 8, 9 and 10, and the directions in paragraphs 130 through 137. As explained in paragraph 23, the evaluation of the materiality of the control deficiency should include both quantitative and qualitative considerations. Qualitative factors that might be important in this evaluation include the nature of the financial statement accounts and assertions involved and the reasonably possible future consequences of the deficiency. Furthermore, in determining whether a control deficiency or combination of deficiencies is a significant deficiency or a material weakness, the auditor should evaluate the effect of compensating controls and whether such compensating controls are effective.

11. Controls over financial reporting may be *preventive controls* or *detective controls*.

- Preventive controls have the objective of preventing errors or fraud from occurring in the first place that could result in a misstatement of the financial statements.

- Detective controls have the objective of detecting errors or fraud that have already occurred that could result in a misstatement of the financial statements.

12. Even well-designed controls that are operating as designed might not prevent a misstatement from occurring. However, this possibility may be countered by overlapping preventive controls or partially countered by detective controls. Therefore, effective internal control over financial reporting often includes a combination of preventive and detective controls to achieve a specific control objective. The auditor's procedures as part of either the audit of internal control over financial reporting or the audit of the financial statements are not part of a company's internal control over financial reporting.

Framework Used by Management to Conduct Its Assessment

13. Management is required to base its assessment of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework established by a body of experts that followed due-process procedures, including the broad distribution of the framework for public comment. In addition to being available to users of management's reports, a framework is suitable only when it:

- Is free from bias;

- Permits reasonably consistent qualitative and quantitative measurements of a company's internal control over financial reporting;

- Is sufficiently complete so that those relevant factors that would alter a conclusion about the effectiveness of a company's internal control over financial reporting are not omitted; and

- Is relevant to an evaluation of internal control over financial reporting.

Committee of Sponsoring Organizations Framework

14. In the United States, the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission has published *Internal Control – Integrated Framework*. Known as the COSO report, it provides a suitable and available framework for purposes of management's assessment. For that reason, the performance and reporting directions in this standard are based on the COSO framework. Other suitable frameworks have been published in other countries and may be developed in the future. Such other suitable frameworks may be used in an audit of internal control over financial reporting. Although different frameworks may not contain exactly the same elements as COSO, they should have elements that encompass, in general, all the themes in COSO. Therefore, the auditor should be able to apply the concepts and guidance in this standard in a reasonable manner.

15. The COSO framework identifies three primary objectives of internal control: efficiency and effectiveness of operations, financial reporting, and compliance with laws and regulations. The COSO perspective on internal control over financial reporting does not ordinarily include the other two objectives of internal control, which are the effectiveness and efficiency of operations and compliance with laws and regulations. However, the controls that management designs and implements may achieve more than one objective. Also, operations and 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. Additionally, not all controls relevant to financial reporting are accounting controls. Accordingly, all controls that could materially affect financial reporting, including controls that focus primarily on the effectiveness and efficiency of operations or compliance with laws and regulations and also have a material effect on the reliability of financial reporting, are a part of internal control over financial reporting. More information about the COSO framework is included in the COSO report and in AU sec. 319, Consideration of Internal Control in a Financial Statement Audit.[3/] The COSO report also discusses special considerations for internal control over financial reporting for small and medium-sized companies.

Inherent Limitations in Internal Control Over Financial Reporting

16. Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations.

[3/] The Board adopted the generally accepted auditing standards, as described in the AICPA Auditing Standards Board's ("ASB") Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards*, as in existence on April 16, 2003, on an initial, transitional basis. The Statements on Auditing Standards promulgated by the ASB have been codified into the AICPA *Professional Standards*, Volume 1, as AU sections 100 through 900. References in this standard to AU sections refer to those generally accepted auditing standards, as adopted on an interim basis in PCAOB Rule 3200T.

Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

The Concept of Reasonable Assurance

17. Management's assessment of the effectiveness of internal control over financial reporting is expressed at the level of *reasonable assurance*. The concept of reasonable assurance is built into the definition of internal control over financial reporting and also is integral to the auditor's opinion.[4/] Reasonable assurance includes the understanding that there is a remote likelihood that material misstatements will not be prevented or detected on a timely basis. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance.

18. Just as there are inherent limitations on the assurance that effective internal control over financial reporting can provide, as discussed in paragraph 16, there are limitations on the amount of assurance the auditor can obtain as a result of performing his or her audit of internal control over financial reporting. Limitations arise because an audit is conducted on a test basis and requires the exercise of professional judgment. Nevertheless, the audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control over financial reporting, and performing such other procedures as the auditor considers necessary to obtain reasonable assurance about whether internal control over financial reporting is effective.

19. There is no difference in the level of work performed or assurance obtained by the auditor when expressing an opinion on management's assessment of effectiveness or when expressing an opinion directly on the effectiveness of internal control over financial reporting. In either case, the auditor must obtain sufficient evidence to provide a reasonable basis for his or her opinion and the use and evaluation of management's assessment is inherent in expressing either opinion.

[4/] See *Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, Securities and Exchange Commission Release No. 33-8238 (June 5, 2003) [68 FR 36636] for further discussion of reasonable assurance.

Note: The auditor's report on internal control over financial reporting does not relieve management of its responsibility for assuring users of its financial reports about the effectiveness of internal control over financial reporting.

Management's Responsibilities in an Audit of Internal Control Over Financial Reporting

20. For the auditor to satisfactorily complete an audit of internal control over financial reporting, management must do the following:[5/]

a. Accept responsibility for the effectiveness of the company's internal control over financial reporting;

b. Evaluate the effectiveness of the company's internal control over financial reporting using suitable control criteria;

c. Support its evaluation with sufficient evidence, including documentation; and

d. Present a written assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year.

21. If the auditor concludes that management has not fulfilled the responsibilities enumerated in the preceding paragraph, the auditor should communicate, in writing, to management and the audit committee that the audit of internal control over financial reporting cannot be satisfactorily completed and that he or she is required to disclaim an opinion. Paragraphs 40 through 46 provide information for the auditor about evaluating management's process for assessing internal control over financial reporting.

Materiality Considerations in an Audit of Internal Control Over Financial Reporting

22. The auditor should apply the concept of materiality in an audit of internal control over financial reporting at both the financial-statement level and at the individual account-balance level. The auditor uses materiality at the financial-statement level in evaluating whether a deficiency, or combination of deficiencies, in controls is a significant deficiency or a material weakness. Materiality at both the financial-statement level and the individual account-balance level is relevant to planning the audit and designing procedures.

[5/] Management is required to fulfill these responsibilities. See Items 308(a) and (c) of Regulation S-B and S-K, 17 C.F.R. 228.308 (a) and (c) and 229.308 (a) and (c), respectively.

Materiality at the account-balance level is necessarily lower than materiality at the financial-statement level.

23. The same conceptual definition of materiality that applies to financial reporting applies to information on internal control over financial reporting, including the relevance of both quantitative and qualitative considerations.[6/]

- The quantitative considerations are essentially the same as in an audit of financial statements and relate to whether misstatements that would not be prevented or detected by internal control over financial reporting, individually or collectively, have a quantitatively material effect on the financial statements.

- The qualitative considerations apply to evaluating materiality with respect to the financial statements and to additional factors that relate to the perceived needs of reasonable persons who will rely on the information. Paragraph 6 describes some qualitative considerations.

Fraud Considerations in an Audit of Internal Control Over Financial Reporting

24. The auditor should evaluate all controls specifically intended to address the risks of fraud that have at least a reasonably possible likelihood of having a material effect on the company's financial statements. These controls may be a part of any of the five components of internal control over financial reporting, as discussed in paragraph 49. Controls related to the prevention and detection of fraud often have a pervasive effect on the risk of fraud. Such controls include, but are not limited to, the:

- Controls restraining misappropriation of company assets that could result in a material misstatement of the financial statements;

- Company's risk assessment processes;

- Code of ethics/conduct provisions, especially those related to conflicts of interest, related party transactions, illegal acts, and the monitoring of the code by management and the audit committee or board;

- Adequacy of the internal audit activity and whether the internal audit function reports directly to the audit committee, as well as the

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[6/] AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, provides additional explanation of materiality.

extent of the audit committee's involvement and interaction with internal audit; and

- Adequacy of the company's procedures for handling complaints and for accepting confidential submissions of concerns about questionable accounting or auditing matters.

25. Part of management's responsibility when designing a company's internal control over financial reporting is to design and implement programs and controls to prevent, deter, and detect fraud. Management, along with those who have responsibility for oversight of the financial reporting process (such as the audit committee), should set the proper tone; create and maintain a culture of honesty and high ethical standards; and establish appropriate controls to prevent, deter, and detect fraud. When management and those responsible for the oversight of the financial reporting process fulfill those responsibilities, the opportunities to commit fraud can be reduced significantly.

26. In an audit of internal control over financial reporting, the auditor's evaluation of controls is interrelated with the auditor's evaluation of controls in a financial statement audit, as required by AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*. Often, controls identified and evaluated by the auditor during the audit of internal control over financial reporting also address or mitigate fraud risks, which the auditor is required to consider in a financial statement audit. If the auditor identifies deficiencies in controls designed to prevent and detect fraud during the audit of internal control over financial reporting, the auditor should alter the nature, timing, or extent of procedures to be performed during the financial statement audit to be responsive to such deficiencies, as provided in paragraphs .44 and .45 of AU sec. 316.

Performing an Audit of Internal Control Over Financial Reporting

27. In an audit of internal control over financial reporting, the auditor must obtain sufficient competent evidence about the design and operating effectiveness of controls over all relevant financial statement assertions related to all significant accounts and disclosures in the financial statements. The auditor must plan and perform the audit to obtain reasonable assurance that deficiencies that, individually or in the aggregate, would represent material weaknesses are identified. Thus, the audit is not designed to detect deficiencies in internal control over financial reporting that, individually or in the aggregate, are less severe than a material weakness. Because of the potential significance of the information obtained during the audit of the financial statements to the auditor's conclusions about the effectiveness of internal control over financial reporting, the auditor cannot audit internal control over financial reporting without also auditing the financial statements.

Note: However, the auditor may audit the financial statements without also auditing internal control over financial reporting, for example, in the case of certain initial public offerings by a company. See the discussion beginning at paragraph 145 for more information about the importance of auditing both internal control over financial reporting as well as the financial statements when the auditor is engaged to audit internal control over financial reporting.

28. The auditor must adhere to the general standards (See paragraphs 30 through 36) and fieldwork and reporting standards (See paragraph 37) in performing an audit of a company's internal control over financial reporting. This involves the following:

a. Planning the engagement;

b. Evaluating management's assessment process;

c. Obtaining an understanding of internal control over financial reporting;

d. Testing and evaluating design effectiveness of internal control over financial reporting;

e. Testing and evaluating operating effectiveness of internal control over financial reporting; and

f. Forming an opinion on the effectiveness of internal control over financial reporting.

29. Even though some requirements of this standard are set forth in a manner that suggests a sequential process, auditing internal control over financial reporting involves a process of gathering, updating, and analyzing information. Accordingly, the auditor may perform some of the procedures and evaluations described in this section on "Performing an Audit of Internal Control Over Financial Reporting" concurrently.

Applying General, Fieldwork, and Reporting Standards

30. The general standards (See AU sec. 150, *Generally Accepted Auditing Standards*) are applicable to an audit of internal control over financial reporting. These standards require technical training and proficiency as an auditor, independence in fact and appearance, and the exercise of due professional care, including professional skepticism.

31. *Technical Training and Proficiency*. To perform an audit of internal control over financial reporting, the auditor should have competence in the subject matter of internal control over financial reporting.

32. *Independence*. The applicable requirements of independence are largely predicated on four basic principles: (1) an auditor must not act as management or as an employee of the audit client, (2) an auditor must not audit his or her own work, (3) an auditor must not serve in a position of being an advocate for his or her client, and (4) an auditor must not have mutual or conflicting interests with his or her audit client.[7/] If the auditor were to design or implement controls, that situation would place the auditor in a management role and result in the auditor auditing his or her own work. These requirements, however, do not preclude the auditor from making substantive recommendations as to how management may improve the design or operation of the company's internal controls as a by-product of an audit.

33. The auditor must not accept an engagement to provide internal control-related services to an issuer for which the auditor also audits the financial statements unless that engagement has been specifically pre-approved by the audit committee. For any internal control services the auditor provides, management must be actively involved and cannot delegate responsibility for these matters to the auditor. Management's involvement must be substantive and extensive. Management's acceptance of responsibility for documentation and testing performed by the auditor does not by itself satisfy the independence requirements.

34. Maintaining independence, in fact and appearance, requires careful attention, as is the case with all independence issues when work concerning internal control over financial reporting is performed. Unless the auditor and the audit committee are diligent in evaluating the nature and extent of services provided, the services might violate basic principles of independence and cause an impairment of independence in fact or appearance.

35. The independent auditor and the audit committee have significant and distinct responsibilities for evaluating whether the auditor's services impair independence in fact or appearance. The test for independence in fact is whether the activities would impede the ability of anyone on the engagement team or in a position to influence the engagement team from exercising objective judgment in the audits of the financial statements or internal control over financial reporting. The test for independence in appearance is whether a reasonable investor, knowing all relevant facts and circumstances, would perceive an auditor as having interests which could jeopardize the exercise of objective and impartial judgments on all issues encompassed within the auditor's engagement.

[7/] See the Preliminary Note of Rule 2-01 of Regulation S-X, 17 C.F.R. 210.2-01.

36. *Due Professional Care*. The auditor must exercise due professional care in an audit of internal control over financial reporting. One important tenet of due professional care is exercising professional skepticism. In an audit of internal control over financial reporting, exercising professional skepticism involves essentially the same considerations as in an audit of financial statements, that is, it includes a critical assessment of the work that management has performed in evaluating and testing controls.

37. *Fieldwork and Reporting Standards*. This standard establishes the fieldwork and reporting standards applicable to an audit of internal control over financial reporting.

38. The concept of materiality, as discussed in paragraphs 22 and 23, underlies the application of the general and fieldwork standards.

Planning the Engagement

39. The audit of internal control over financial reporting should be properly planned and assistants, if any, are to be properly supervised. When planning the audit of internal control over financial reporting, the auditor should evaluate how the following matters will affect the auditor's procedures:

- Knowledge of the company's internal control over financial reporting obtained during other engagements.
- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes.
- Matters relating to the company's business, including its organization, operating characteristics, capital structure, and distribution methods.
- The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting.
- Management's process for assessing the effectiveness of the company's internal control over financial reporting based upon control criteria.
- Preliminary judgments about materiality, risk, and other factors relating to the determination of material weaknesses.
- Control deficiencies previously communicated to the audit committee or management.

- Legal or regulatory matters of which the company is aware.

- The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting.

- Preliminary judgments about the effectiveness of internal control over financial reporting.

- The number of significant business locations or units, including management's documentation and monitoring of controls over such locations or business units. (Appendix B, paragraphs B1 through B17, discusses factors the auditor should evaluate to determine the locations at which to perform auditing procedures.)

Evaluating Management's Assessment Process

40. The auditor must obtain an understanding of, and evaluate, management's process for assessing the effectiveness of the company's internal control over financial reporting. When obtaining the understanding, the auditor should determine whether management has addressed the following elements:

- Determining which controls should be tested, including controls over all relevant assertions related to all significant accounts and disclosures in the financial statements. Generally, such controls include:

  – Controls over initiating, authorizing, recording, processing, and reporting significant accounts and disclosures and related assertions embodied in the financial statements.

  – Controls over the selection and application of accounting policies that are in conformity with generally accepted accounting principles.

  – Antifraud programs and controls.

  – Controls, including information technology general controls, on which other controls are dependent.

  – Controls over significant nonroutine and nonsystematic transactions, such as accounts involving judgments and estimates.

- – Company level controls (as described in paragraph 53), including:

  - – The control environment and

  - – Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; to initiate, authorize, record, and process journal entries in the general ledger; and to record recurring and nonrecurring adjustments to the financial statements (for example, consolidating adjustments, report combinations, and reclassifications).

    Note: References to the period-end financial reporting process in this standard refer to the preparation of both annual and quarterly financial statements.

- Evaluating the likelihood that failure of the control could result in a misstatement, the magnitude of such a misstatement, and the degree to which other controls, if effective, achieve the same control objectives.

- Determining the locations or business units to include in the evaluation for a company with multiple locations or business units (See paragraphs B1 through B17).

- Evaluating the design effectiveness of controls.

- Evaluating the operating effectiveness of controls based on procedures sufficient to assess their operating effectiveness. Examples of such procedures include testing of the controls by internal audit, testing of controls by others under the direction of management, using a service organization's reports (See paragraphs B18 through B29), inspection of evidence of the application of controls, or testing by means of a self-assessment process, some of which might occur as part of management's ongoing monitoring activities. Inquiry alone is not adequate to complete this evaluation. To evaluate the effectiveness of the company's internal control over financial reporting, management must have evaluated controls over all relevant assertions related to all significant accounts and disclosures.

- Determining the deficiencies in internal control over financial reporting that are of such a magnitude and likelihood of occurrence that they constitute significant deficiencies or material weaknesses.

- Communicating findings to the auditor and to others, if applicable.

- Evaluating whether findings are reasonable and support management's assessment.

41. As part of the understanding and evaluation of management's process, the auditor should obtain an understanding of the results of procedures performed by others. Others include internal audit and third parties working under the direction of management, including other auditors and accounting professionals engaged to perform procedures as a basis for management's assessment. Inquiry of management and others is the beginning point for obtaining an understanding of internal control over financial reporting, but inquiry alone is not adequate for reaching a conclusion on any aspect of internal control over financial reporting effectiveness.

Note: Management cannot use the auditor's procedures as part of the basis for its assessment of the effectiveness of internal control over financial reporting.

42. *Management's Documentation*. When determining whether management's documentation provides reasonable support for its assessment, the auditor should evaluate whether such documentation includes the following:

- The design of controls over all relevant assertions related to all significant accounts and disclosures in the financial statements. The documentation should include the five components of internal control over financial reporting as discussed in paragraph 49, including the control environment and company-level controls as described in paragraph 53;

- Information about how significant transactions are initiated, authorized, recorded, processed and reported;

- Sufficient information about the flow of transactions to identify the points at which material misstatements due to error or fraud could occur;

- Controls designed to prevent or detect fraud, including who performs the controls and the related segregation of duties;

- Controls over the period-end financial reporting process;

- Controls over safeguarding of assets (See paragraphs C1 through C6); and

- The results of management's testing and evaluation.

43. Documentation might take many forms, such as paper, electronic files, or other media, and can include a variety of information, including policy manuals, process models, flowcharts, job descriptions, documents, and forms. The form and extent of documentation will vary depending on the size, nature, and complexity of the company.

44. Documentation of the design of controls over relevant assertions related to significant accounts and disclosures is evidence that controls related to management's assessment of the effectiveness of internal control over financial reporting, including changes to those controls, have been identified, are capable of being communicated to those responsible for their performance, and are capable of being monitored by the company. Such documentation also provides the foundation for appropriate communication concerning responsibilities for performing controls and for the company's evaluation of and monitoring of the effective operation of controls.

45. Inadequate documentation of the design of controls over relevant assertions related to significant accounts and disclosures is a deficiency in the company's internal control over financial reporting. As discussed in paragraph 138, the auditor should evaluate this documentation deficiency. The auditor might conclude that the deficiency is only a deficiency, or that the deficiency represents a significant deficiency or a material weakness. In evaluating the deficiency as to its significance, the auditor should determine whether management can demonstrate the monitoring component of internal control over financial reporting.

46. Inadequate documentation also could cause the auditor to conclude that there is a limitation on the scope of the engagement.

Obtaining an Understanding of Internal Control Over Financial Reporting

47. The auditor should obtain an understanding of the design of specific controls by applying procedures that include:

- Making inquiries of appropriate management, supervisory, and staff personnel;

- Inspecting company documents;

- Observing the application of specific controls; and

- Tracing transactions through the information system relevant to financial reporting.

48. The auditor could also apply additional procedures to obtain an understanding of the design of specific controls.

49. The auditor must obtain an understanding of the design of controls related to each component of internal control over financial reporting, as discussed below.

- *Control Environment*. Because of the pervasive effect of the control environment on the reliability of financial reporting, the auditor's preliminary judgment about its effectiveness often influences the nature, timing, and extent of the tests of operating effectiveness considered necessary. Weaknesses in the control environment should cause the auditor to alter the nature, timing, or extent of tests of operating effectiveness that otherwise should have been performed in the absence of the weaknesses.

- *Risk Assessment*. When obtaining an understanding of the company's risk assessment process, the auditor should evaluate whether management has identified the risks of material misstatement in the significant accounts and disclosures and related assertions of the financial statements and has implemented controls to prevent or detect errors or fraud that could result in material misstatements. For example, the risk assessment process should address how management considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements. Risks relevant to reliable financial reporting also relate to specific events or transactions.

- *Control Activities*. The auditor's understanding of control activities relates to the controls that management has implemented to prevent or detect errors or fraud that could result in material misstatement in the accounts and disclosures and related assertions of the financial statements. For the purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained for the financial statement audit.

- *Information and Communication*. The auditor's understanding of management's information and communication involves understanding the same systems and processes that he or she addresses in an audit of financial statements. In addition, this understanding includes a greater emphasis on comprehending the safeguarding controls and the processes for authorization of transactions and the maintenance of records, as well as the period-end financial reporting process (discussed further beginning at paragraph 76).

- *Monitoring*. The auditor's understanding of management's monitoring of controls extends to and includes its monitoring of all controls, including control activities, which management has identified and designed to prevent or detect material misstatement in the accounts and disclosures and related assertions of the financial statements.

50. Some controls (such as company-level controls, described in paragraph 53) might have a pervasive effect on the achievement of many overall objectives of the control criteria. For example, information technology general controls over program development, program changes, computer operations, and access to programs and data help ensure that specific controls over the processing of transactions are operating effectively. In contrast, other controls are designed to achieve specific objectives of the control criteria. For example, management generally establishes specific controls, such as accounting for all shipping documents, to ensure that all valid sales are recorded.

51. The auditor should focus on combinations of controls, in addition to specific controls in isolation, in assessing whether the objectives of the control criteria have been achieved. The absence or inadequacy of a specific control designed to achieve the objectives of a specific criterion might not be a deficiency if other controls specifically address the same criterion. Further, when one or more controls achieve the objectives of a specific criterion, the auditor might not need to evaluate other controls designed to achieve those same objectives.

52. *Identifying Company-Level Controls*. Controls that exist at the company-level often have a pervasive impact on controls at the process, transaction, or application level. For that reason, as a practical consideration, it may be appropriate for the auditor to test and evaluate the design effectiveness of company-level controls first, because the results of that work might affect the way the auditor evaluates the other aspects of internal control over financial reporting.

53. Company-level controls are controls such as the following:

- Controls within the control environment, including tone at the top, the assignment of authority and responsibility, consistent policies and procedures, and company-wide programs, such as codes of conduct and fraud prevention, that apply to all locations and business units (See paragraphs 113 through 115 for further discussion);

- Management's risk assessment process;
- Centralized processing and controls, including shared service environments;
- Controls to monitor results of operations;
- Controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs;
- The period-end financial reporting process; and
- Board-approved policies that address significant business control and risk management practices.

Note: The controls listed above are not intended to be a complete list of company-level controls nor is a company required to have all the controls in the list to support its assessment of effective company-level controls. However, ineffective company-level controls are a deficiency that will affect the scope of work performed, particularly when a company has multiple locations or business units, as described in Appendix B.

54. Testing company-level controls alone is not sufficient for the purpose of expressing an opinion on the effectiveness of a company's internal control over financial reporting.

55. *Evaluating the Effectiveness of the Audit Committee's Oversight of the Company's External Financial Reporting and Internal Control Over Financial Reporting*. The company's audit committee plays an important role within the control environment and monitoring components of internal control over financial reporting. Within the control environment, the existence of an effective audit committee helps to set a positive tone at the top. Within the monitoring component, an effective audit committee challenges the company's activities in the financial arena.

Note: Although the audit committee plays an important role within the control environment and monitoring components of internal control over financial reporting, management is responsible for maintaining effective internal control over financial reporting. This standard does not suggest that this responsibility has been transferred to the audit committee.

Note: If no such committee exists with respect to the company, all references to the audit committee in this standard apply to the entire board of directors of the company.[8/] The auditor should be aware that companies whose securities are not listed on a national securities exchange or an automated inter-dealer quotation system of a national securities association (such as the New York Stock Exchange, American Stock Exchange, or NASDAQ) may not be required to have independent directors for their audit committees. In this case, the auditor should not consider the lack of independent directors at these companies indicative, by itself, of a control deficiency. Likewise, the independence requirements of Securities Exchange Act Rule 10A-3[9/] are not applicable to the listing of non-equity securities of a consolidated or at least 50 percent beneficially owned subsidiary of a listed issuer that is subject to the requirements of Securities Exchange Act Rule 10A-3(c)(2).[10/] Therefore, the auditor should interpret references to the audit committee in this standard, as applied to a subsidiary registrant, as being consistent with the provisions of Securities Exchange Act Rule 10A-3(c)(2).[11/] Furthermore, for subsidiary registrants, communications required by this standard to be directed to the audit committee should be made to the same committee or equivalent body that pre-approves the retention of the auditor by or on behalf of the subsidiary registrant pursuant to Rule 2-01(c)(7) of Regulation S-X[12/] (which might be, for example, the audit committee of the subsidiary registrant, the full board of the subsidiary registrant, or the audit committee of the subsidiary registrant's parent). In all cases, the auditor should interpret the terms "board of directors" and "audit committee" in this standard as being consistent with provisions for the use of those terms as defined in relevant SEC rules.

56. The company's board of directors is responsible for evaluating the performance and effectiveness of the audit committee; this standard does not suggest that the auditor is responsible for performing a separate and distinct evaluation of the audit committee. However, because of the role of the audit committee within the control environment and monitoring components of internal control over financial reporting, the auditor should assess the effectiveness of the audit committee as part of understanding and evaluating those components.

57. The aspects of the audit committee's effectiveness that are important may vary considerably with the circumstances. The auditor focuses on factors related

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8/ See 15 U.S.C. 78c(a)58 and 15 U.S.C. 7201(a)(3).

9/ See 17 C.F.R. 240.10A-3.

10/ See 17 C.F.R. 240.10A-3(c)(2).

11/ See 17 C.F.R. 240.10A-3(c)(2).

12/ See 17 C.F.R. 210.2-01(c)(7).

to the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting, such as the independence of the audit committee members from management and the clarity with which the audit committee's responsibilities are articulated (for example, in the audit committee's charter) and how well the audit committee and management understand those responsibilities. The auditor might also consider the audit committee's involvement and interaction with the independent auditor and with internal auditors, as well as interaction with key members of financial management, including the chief financial officer and chief accounting officer.

58. The auditor might also evaluate whether the right questions are raised and pursued with management and the auditor, including questions that indicate an understanding of the critical accounting policies and judgmental accounting estimates, and the responsiveness to issues raised by the auditor.

59. Ineffective oversight by the audit committee of the company's external financial reporting and internal control over financial reporting should be regarded as at least a significant deficiency and is a strong indicator that a material weakness in internal control over financial reporting exists.

60. *Identifying Significant Accounts*. The auditor should identify significant accounts and disclosures, first at the financial-statement level and then at the account or disclosure-component level. Determining specific controls to test begins by identifying significant accounts and disclosures within the financial statements. When identifying significant accounts, the auditor should evaluate both quantitative and qualitative factors.

61. An account is significant if there is more than a remote likelihood that the account could contain misstatements that individually, or when aggregated with others, could have a material effect on the financial statements, considering the risks of both overstatement and understatement. Other accounts may be significant on a qualitative basis based on the expectations of a reasonable user. For example, investors might be interested in a particular financial statement account even though it is not quantitatively large because it represents an important performance measure.

> Note: For purposes of determining significant accounts, the assessment as to likelihood should be made without giving any consideration to the effectiveness of internal control over financial reporting.

62. Components of an account balance subject to differing risks (inherent and control) or different controls should be considered separately as potential significant accounts. For instance, inventory accounts often consist of raw materials (purchasing process), work in process (manufacturing process), finished goods (distribution process), and an allowance for obsolescence.

63. In some cases, separate components of an account might be a significant account because of the company's organizational structure. For example, for a company that has a number of separate business units, each with different management and accounting processes, the accounts at each separate business unit are considered individually as potential significant accounts.

64. An account also may be considered significant because of the exposure to unrecognized obligations represented by the account. For example, loss reserves related to a self-insurance program or unrecorded contractual obligations at a construction contracting subsidiary may have historically been insignificant in amount, yet might represent a more than remote likelihood of material misstatement due to the existence of material unrecorded claims.

65. When deciding whether an account is significant, it is important for the auditor to evaluate both quantitative and qualitative factors, including the:

- Size and composition of the account;
- Susceptibility of loss due to errors or fraud;
- Volume of activity, complexity, and homogeneity of the individual transactions processed through the account;
- Nature of the account (for example, suspense accounts generally warrant greater attention);
- Accounting and reporting complexities associated with the account;
- Exposure to losses represented by the account (for example, loss accruals related to a consolidated construction contracting subsidiary);
- Likelihood (or possibility) of significant contingent liabilities arising from the activities represented by the account;
- Existence of related party transactions in the account; and
- Changes from the prior period in account characteristics (for example, new complexities or subjectivity or new types of transactions).

66. For example, in a financial statement audit, the auditor might not consider the fixed asset accounts significant when there is a low volume of transactions and when inherent risk is assessed as low, even though the balances are material to the financial statements. Accordingly, he or she might decide to perform only substantive procedures on such balances. In an audit of internal

control over financial reporting, however, such accounts are significant accounts because of their materiality to the financial statements.

67. As another example, the auditor of the financial statements of a financial institution might not consider trust accounts significant to the institution's financial statements because such accounts are not included in the institution's balance sheet and the associated fee income generated by trust activities is not material. However, in determining whether trust accounts are a significant account for purposes of the audit of internal control over financial reporting, the auditor should assess whether the activities of the trust department are significant to the institution's financial reporting, which also would include considering the contingent liabilities that could arise if a trust department failed to fulfill its fiduciary responsibilities (for example, if investments were made that were not in accordance with stated investment policies). When assessing the significance of possible contingent liabilities, consideration of the amount of assets under the trust department's control may be useful. For this reason, an auditor who has not considered trust accounts significant accounts for purposes of the financial statement audit might determine that they are significant for purposes of the audit of internal control over financial reporting.

68. Identifying Relevant Financial Statement Assertions. For each significant account, the auditor should determine the relevance of each of these financial statement assertions:[13/]

- Existence or occurrence;
- Completeness;
- Valuation or allocation;
- Rights and obligations; and
- Presentation and disclosure.

69. To identify relevant assertions, the auditor should determine the source of likely potential misstatements in each significant account. In determining whether a particular assertion is relevant to a significant account balance or disclosure, the auditor should evaluate:

- The nature of the assertion;
- The volume of transactions or data related to the assertion; and

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13/ See AU sec. 326, *Evidential Matter*, which provides additional information on financial statement assertions.

- The nature and complexity of the systems, including the use of information technology by which the company processes and controls information supporting the assertion.

70. *Relevant assertions* are assertions that have a meaningful bearing on whether the account is fairly stated. For example, valuation may not be relevant to the cash account unless currency translation is involved; however, existence and completeness are always relevant. Similarly, valuation may not be relevant to the gross amount of the accounts receivable balance, but is relevant to the related allowance accounts. Additionally, the auditor might, in some circumstances, focus on the presentation and disclosure assertion separately in connection with the period-end financial reporting process.

71. *Identifying Significant Processes and Major Classes of Transactions*. The auditor should identify each significant process over each major class of transactions affecting significant accounts or groups of accounts. Major classes of transactions are those classes of transactions that are significant to the company's financial statements. For example, at a company whose sales may be initiated by customers through personal contact in a retail store or electronically through use of the internet, these types of sales would be two major classes of transactions within the sales process if they were both significant to the company's financial statements. As another example, at a company for which fixed assets is a significant account, recording depreciation expense would be a major class of transactions.

72. Different types of major classes of transactions have different levels of inherent risk associated with them and require different levels of management supervision and involvement. For this reason, the auditor might further categorize the identified major classes of transactions by transaction type: routine, nonroutine, and estimation.

- Routine transactions are recurring financial activities reflected in the accounting records in the normal course of business (for example, sales, purchases, cash receipts, cash disbursements, payroll).

- Nonroutine transactions are activities that occur only periodically (for example, taking physical inventory, calculating depreciation expense, adjusting for foreign currencies). A distinguishing feature of nonroutine transactions is that data involved are generally not part of the routine flow of transactions.

- Estimation transactions are activities that involve management judgments or assumptions in formulating account balances in the absence of a precise means of measurement (for example, determining the allowance for doubtful accounts, establishing warranty reserves, assessing assets for impairment).

73. Most processes involve a series of tasks such as capturing input data, sorting and merging data, making calculations, updating transactions and master files, generating transactions, and summarizing and displaying or reporting data. The processing procedures relevant for the auditor to understand the flow of transactions generally are those activities required to initiate, authorize, record, process and report transactions. Such activities include, for example, initially recording sales orders, preparing shipping documents and invoices, and updating the accounts receivable master file. The relevant processing procedures also include procedures for correcting and reprocessing previously rejected transactions and for correcting erroneous transactions through adjusting journal entries.

74. For each significant process, the auditor should:

- Understand the flow of transactions, including how transactions are initiated, authorized, recorded, processed, and reported.

- Identify the points within the process at which a misstatement – including a misstatement due to fraud – related to each relevant financial statement assertion could arise.

- Identify the controls that management has implemented to address these potential misstatements.

- Identify the controls that management has implemented over the prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets.

Note: The auditor frequently obtains the understanding and identifies the controls described above as part of his or her performance of walkthroughs (as described beginning in paragraph 79).

75. The nature and characteristics of a company's use of information technology in its information system affect the company's internal control over financial reporting. AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, paragraphs .16 through .20, .30 through .32, and .77 through .79, discuss the effect of information technology on internal control over financial reporting.

76. *Understanding the Period-end Financial Reporting Process*. The period-end financial reporting process includes the following:

- The procedures used to enter transaction totals into the general ledger;

- The procedures used to initiate, authorize, record, and process journal entries in the general ledger;

- Other procedures used to record recurring and nonrecurring adjustments to the annual and quarterly financial statements, such as consolidating adjustments, report combinations, and classifications; and

- Procedures for drafting annual and quarterly financial statements and related disclosures.

77. As part of understanding and evaluating the period-end financial reporting process, the auditor should evaluate:

- The inputs, procedures performed, and outputs of the processes the company uses to produce its annual and quarterly financial statements;

- The extent of information technology involvement in each period-end financial reporting process element;

- Who participates from management;

- The number of locations involved;

- Types of adjusting entries (for example, standard, nonstandard, eliminating, and consolidating); and

- The nature and extent of the oversight of the process by appropriate parties, including management, the board of directors, and the audit committee.

78. The period-end financial reporting process is always a significant process because of its importance to financial reporting and to the auditor's opinions on internal control over financial reporting and the financial statements. The auditor's understanding of the company's period-end financial reporting process and how it interrelates with the company's other significant processes assists the auditor in identifying and testing controls that are the most relevant to financial statement risks.

79. *Performing Walkthroughs*. The auditor should perform at least one walkthrough for each major class of transactions (as identified in paragraph 71). In a walkthrough, the auditor traces a transaction from origination through the

company's information systems until it is reflected in the company's financial reports. Walkthroughs provide the auditor with evidence to:

- Confirm the auditor's understanding of the process flow of transactions;

- Confirm the auditor's understanding of the design of controls identified for all five components of internal control over financial reporting, including those related to the prevention or detection of fraud;

- Confirm that the auditor's understanding of the process is complete by determining whether all points in the process at which misstatements related to each relevant financial statement assertion that could occur have been identified;

- Evaluate the effectiveness of the design of controls; and

- Confirm whether controls have been placed in operation.

Note: The auditor can often gain an understanding of the transaction flow, identify and understand controls, and conduct the walkthrough simultaneously.

80. The auditor's walkthroughs should encompass the entire process of initiating, authorizing, recording, processing, and reporting individual transactions and controls for each of the significant processes identified, including controls intended to address the risk of fraud. During the walkthrough, at each point at which important processing procedures or controls occur, the auditor should question the company's personnel about their understanding of what is required by the company's prescribed procedures and controls and determine whether the processing procedures are performed as originally understood and on a timely basis. (Controls might not be performed regularly but still be timely.) During the walkthrough, the auditor should be alert for exceptions to the company's prescribed procedures and controls.

81. While performing a walkthrough, the auditor should evaluate the quality of the evidence obtained and perform walkthrough procedures that produce a level of evidence consistent with the objectives listed in paragraph 79. Rather than reviewing copies of documents and making inquiries of a single person at the company, the auditor should follow the process flow of actual transactions using the same documents and information technology that company personnel use and make inquiries of relevant personnel involved in significant aspects of the process or controls. To corroborate information at various points in the walkthrough, the auditor might ask personnel to describe their understanding of the previous and succeeding processing or control activities and to demonstrate

what they do. In addition, inquiries should include follow-up questions that could help identify the abuse of controls or indicators of fraud. Examples of follow-up inquiries include asking personnel:

- What they do when they find an error or what they are looking for to determine if there is an error (rather than simply asking them if they perform listed procedures and controls); what kind of errors they have found; what happened as a result of finding the errors, and how the errors were resolved. If the person being interviewed has never found an error, the auditor should evaluate whether that situation is due to good preventive controls or whether the individual performing the control lacks the necessary skills.

- Whether they have ever been asked to override the process or controls, and if so, to describe the situation, why it occurred, and what happened.

82. During the period under audit, when there have been significant changes in the process flow of transactions, including the supporting computer applications, the auditor should evaluate the nature of the change(s) and the effect on related accounts to determine whether to walk through transactions that were processed both before and after the change.

> Note: Unless significant changes in the process flow of transactions, including the supporting computer applications, make it more efficient for the auditor to prepare new documentation of a walkthrough, the auditor may carry his or her documentation forward each year, after updating it for any changes that have taken place.

83. *Identifying Controls to Test*. The auditor should obtain evidence about the effectiveness of controls (either by performing tests of controls himself or herself, or by using the work of others)[14/] for all relevant assertions related to all significant accounts and disclosures in the financial statements. After identifying significant accounts, relevant assertions, and significant processes, the auditor should evaluate the following to identify the controls to be tested:

- Points at which errors or fraud could occur;

- The nature of the controls implemented by management;

- The significance of each control in achieving the objectives of the control criteria and whether more than one control achieves a

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14/ See paragraphs 108 through 126 for additional direction on using the work of others.

particular objective or whether more than one control is necessary to achieve a particular objective; and

- The risk that the controls might not be operating effectively. Factors that affect whether the control might not be operating effectively include the following:

  – Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness;

  – Whether there have been changes in the design of controls;

  – The degree to which the control relies on the effectiveness of other controls (for example, the control environment or information technology general controls);

  – Whether there have been changes in key personnel who perform the control or monitor its performance;

  – Whether the control relies on performance by an individual or is automated; and

  – The complexity of the control.

84. The auditor should clearly link individual controls with the significant accounts and assertions to which they relate.

85. The auditor should evaluate whether to test preventive controls, detective controls, or a combination of both for individual relevant assertions related to individual significant accounts. For instance, when performing tests of preventive and detective controls, the auditor might conclude that a deficient preventive control could be compensated for by an effective detective control and, therefore, not result in a significant deficiency or material weakness. For example, a monthly reconciliation control procedure, which is a detective control, might detect an out-of-balance situation resulting from an unauthorized transaction being initiated due to an ineffective authorization procedure, which is a preventive control. When determining whether the detective control is effective, the auditor should evaluate whether the detective control is sufficient to achieve the control objective to which the preventive control relates.

> Note: Because effective internal control over financial reporting often includes a combination of preventive and detective controls, the auditor ordinarily will test a combination of both.

86. The auditor should apply tests of controls to those controls that are important to achieving each control objective. It is neither necessary to test all controls nor is it necessary to test redundant controls (that is, controls that duplicate other controls that achieve the same objective and already have been tested), unless redundancy is itself a control objective, as in the case of certain computer controls.

87. Appendix B, paragraphs B1 through B17, provide additional direction to the auditor in determining which controls to test when a company has multiple locations or business units. In these circumstances, the auditor should determine significant accounts and their relevant assertions, significant processes, and major classes of transactions based on those that are relevant and significant to the consolidated financial statements. Having made those determinations in relation to the consolidated financial statements, the auditor should then apply the directions in Appendix B.

Testing and Evaluating Design Effectiveness

88. Internal control over financial reporting is effectively designed when the controls complied with would be expected to prevent or detect errors or fraud that could result in material misstatements in the financial statements. The auditor should determine whether the company has controls to meet the objectives of the control criteria by:

- Identifying the company's control objectives in each area;
- Identifying the controls that satisfy each objective; and
- Determining whether the controls, if operating properly, can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.

89. Procedures the auditor performs to test and evaluate design effectiveness include inquiry, observation, walkthroughs, inspection of relevant documentation, and a specific evaluation of whether the controls are likely to prevent or detect errors or fraud that could result in misstatements if they are operated as prescribed by appropriately qualified persons.

90. The procedures that the auditor performs in evaluating management's assessment process and obtaining an understanding of internal control over financial reporting also provide the auditor with evidence about the design effectiveness of internal control over financial reporting.

91. The procedures the auditor performs to test and evaluate design effectiveness also might provide evidence about operating effectiveness.

Testing and Evaluating Operating Effectiveness

92. An auditor should evaluate the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and qualifications to perform the control effectively.

93. *Nature of Tests of Controls*. Tests of controls over operating effectiveness should include a mix of inquiries of appropriate personnel, inspection of relevant documentation, observation of the company's operations, and reperformance of the application of the control. For example, the auditor might observe the procedures for opening the mail and processing cash receipts to test the operating effectiveness of controls over cash receipts. Because an observation is pertinent only at the point in time at which it is made, the auditor should supplement the observation with inquiries of company personnel and inspection of documentation about the operation of such controls at other times. These inquiries might be made concurrently with performing walkthroughs.

94. Inquiry is a procedure that consists of seeking information, both financial and nonfinancial, of knowledgeable persons throughout the company. Inquiry is used extensively throughout the audit and often is complementary to performing other procedures. Inquiries may range from formal written inquiries to informal oral inquiries.

95. Evaluating responses to inquiries is an integral part of the inquiry procedure. Examples of information that inquiries might provide include the skill and competency of those performing the control, the relative sensitivity of the control to prevent or detect errors or fraud, and the frequency with which the control operates to prevent or detect errors or fraud. Responses to inquiries might provide the auditor with information not previously possessed or with corroborative evidence. Alternatively, responses might provide information that differs significantly from other information the auditor obtains (for example, information regarding the possibility of management override of controls). In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional procedures.

96. Because inquiry alone does not provide sufficient evidence to support the operating effectiveness of a control, the auditor should perform additional tests of controls. For example, if the company implements a control activity whereby its sales manager reviews and investigates a report of invoices with unusually high or low gross margins, inquiry of the sales manager as to whether he or she investigates discrepancies would be inadequate. To obtain sufficient evidence about the operating effectiveness of the control, the auditor should corroborate the sales manager's responses by performing other procedures, such as inspecting reports or other documentation used in or generated by the

performance of the control, and evaluate whether appropriate actions were taken regarding discrepancies.

97. The nature of the control also influences the nature of the tests of controls the auditor can perform. For example, the auditor might examine documents regarding controls for which documentary evidence exists. However, documentary evidence regarding some aspects of the control environment, such as management's philosophy and operating style, might not exist. In circumstances in which documentary evidence of controls or the performance of controls does not exist and is not expected to exist, the auditor's tests of controls would consist of inquiries of appropriate personnel and observation of company activities. As another example, a signature on a voucher package to indicate that the signer approved it does not necessarily mean that the person carefully reviewed the package before signing. The package may have been signed based on only a cursory review (or without any review). As a result, the quality of the evidence regarding the effective operation of the control might not be sufficiently persuasive. If that is the case, the auditor should reperform the control (for example, checking prices, extensions, and additions) as part of the test of the control. In addition, the auditor might inquire of the person responsible for approving voucher packages what he or she looks for when approving packages and how many errors have been found within voucher packages. The auditor also might inquire of supervisors whether they have any knowledge of errors that the person responsible for approving the voucher packages failed to detect.

98. *Timing of Tests of Controls*. The auditor must perform tests of controls over a period of time that is adequate to determine whether, as of the date specified in management's report, the controls necessary for achieving the objectives of the control criteria are operating effectively. The period of time over which the auditor performs tests of controls varies with the nature of the controls being tested and with the frequency with which specific controls operate and specific policies are applied. Some controls operate continuously (for example, controls over sales), while others operate only at certain times (for example, controls over the preparation of monthly or quarterly financial statements and controls over physical inventory counts).

99. The auditor's testing of the operating effectiveness of such controls should occur at the time the controls are operating. Controls "as of" a specific date encompass controls that are relevant to the company's internal control over financial reporting "as of" that specific date, even though such controls might not operate until after that specific date. For example, some controls over the period-end financial reporting process normally operate only after the "as of" date. Therefore, if controls over the December 31, 20X4 period-end financial reporting process operate in January 20X5, the auditor should test the control operating in January 20X5 to have sufficient evidence of operating effectiveness "as of" December 31, 20X4.

100. When the auditor reports on the effectiveness of controls "as of" a specific date and obtains evidence about the operating effectiveness of controls at an interim date, he or she should determine what additional evidence to obtain concerning the operation of the control for the remaining period. In making that determination, the auditor should evaluate:

- The specific controls tested prior to the "as of" date and the results of those tests;
- The degree to which evidence about the operating effectiveness of those controls was obtained;
- The length of the remaining period; and
- The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date.

101. For controls over significant nonroutine transactions, controls over accounts or processes with a high degree of subjectivity or judgment in measurement, or controls over the recording of period-end adjustments, the auditor should perform tests of controls closer to or at the "as of" date rather than at an interim date. However, the auditor should balance performing the tests of controls closer to the "as of" date with the need to obtain sufficient evidence of operating effectiveness.

102. Prior to the date specified in management's report, management might implement changes to the company's controls to make them more effective or efficient or to address control deficiencies. In that case, the auditor might not need to evaluate controls that have been superseded. For example, if the auditor determines that the new controls achieve the related objectives of the control criteria and have been in effect for a sufficient period to permit the auditor to assess their design and operating effectiveness by performing tests of controls,[15/] he or she will not need to evaluate the design and operating effectiveness of the superseded controls for purposes of expressing an opinion on internal control over financial reporting.

103. As discussed in paragraph 207, however, the auditor must communicate all identified significant deficiencies and material weaknesses in controls to the audit committee in writing. In addition, the auditor should evaluate how the

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[15/] Paragraph 179 provides reporting directions in these circumstances when the auditor has not been able to obtain evidence that the new controls were appropriately designed or have been operating effectively for a sufficient period of time.

design and operating effectiveness of the superseded controls relates to the auditor's reliance on controls for financial statement audit purposes.

104. *Extent of Tests of Controls*. Each year the auditor must obtain sufficient evidence about whether the company's internal control over financial reporting, including the controls for all internal control components, is operating effectively. This means that each year the auditor must obtain evidence about the effectiveness of controls for all relevant assertions related to all significant accounts and disclosures in the financial statements. The auditor also should vary from year to year the nature, timing, and extent of testing of controls to introduce unpredictability into the testing and respond to changes in circumstances. For example, each year the auditor might test the controls at a different interim period; increase or reduce the number and types of tests performed; or change the combination of procedures used.

105. In determining the extent of procedures to perform, the auditor should design the procedures to provide a high level of assurance that the control being tested is operating effectively. In making this determination, the auditor should assess the following factors:

- *Nature of the control*. The auditor should subject manual controls to more extensive testing than automated controls. In some circumstances, testing a single operation of an automated control may be sufficient to obtain a high level of assurance that the control operated effectively, provided that information technology general controls also are operating effectively. For manual controls, sufficient evidence about the operating effectiveness of the controls is obtained by evaluating multiple operations of the control and the results of each operation. The auditor also should assess the complexity of the controls, the significance of the judgments that must be made in connection with their operation, and the level of competence of the person performing the controls that is necessary for the control to operate effectively. As the complexity and level of judgment increase or the level of competence of the person performing the control decreases, the extent of the auditor's testing should increase.

- *Frequency of operation*. Generally, the more frequently a manual control operates, the more operations of the control the auditor should test. For example, for a manual control that operates in connection with each transaction, the auditor should test multiple operations of the control over a sufficient period of time to obtain a high level of assurance that the control operated effectively. For controls that operate less frequently, such as monthly account reconciliations and controls over the period-end financial reporting process, the auditor may test significantly fewer operations of the control. However, the auditor's evaluation of each operation of controls operating less frequently is likely to be more extensive. For example, when evaluating the operation of a monthly exception report, the auditor should evaluate whether the judgments made with regard to the disposition of the exceptions were appropriate and adequately supported.

Note: When sampling is appropriate and the population of controls to be tested is large, increasing the population size does not proportionately increase the required sample size.

- *Importance of the control*. Controls that are relatively more important should be tested more extensively. For example, some controls may address multiple financial statement assertions, and certain period-end detective controls might be considered more important than related preventive controls. The auditor should test more operations of such controls or, if such controls operate infrequently, the auditor should evaluate each operation of the control more extensively.

106. *Use of Professional Skepticism when Evaluating the Results of Testing*. The auditor must conduct the audit of internal control over financial reporting and the audit of the financial statements with professional skepticism, which is an attitude that includes a questioning mind and a critical assessment of audit evidence. For example, even though a control is performed by the same employee whom the auditor believes performed the control effectively in prior periods, the control may not be operating effectively during the current period because the employee could have become complacent, distracted, or otherwise not be effectively carrying out his or her responsibilities. Also, regardless of any past experience with the entity or the auditor's beliefs about management's honesty and integrity, the auditor should recognize the possibility that a material misstatement due to fraud could be present. Furthermore, professional skepticism requires the auditor to consider whether evidence obtained suggests that a material misstatement due to fraud has occurred. In exercising professional skepticism in gathering and evaluating evidence, the auditor must not be satisfied with less-than-persuasive evidence because of a belief that management is honest.

107. When the auditor identifies exceptions to the company's prescribed control procedures, he or she should determine, using professional skepticism, the effect of the exception on the nature and extent of additional testing that may be appropriate or necessary and on the operating effectiveness of the control being tested. A conclusion that an identified exception does not represent a control deficiency is appropriate only if evidence beyond what the auditor had initially planned and beyond inquiry supports that conclusion.

Using the Work of Others

108. In all audits of internal control over financial reporting, the auditor must perform enough of the testing himself or herself so that the auditor's own work provides the principal evidence for the auditor's opinion. The auditor may, however, use the work of others to alter the nature, timing, or extent of the work he or she otherwise would have performed. For these purposes, the work of others includes relevant work performed by internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee that provides information about the effectiveness of internal control over financial reporting.

> Note: Because the amount of work related to obtaining sufficient evidence to support an opinion about the effectiveness of controls is not susceptible to precise measurement, the auditor's judgment about whether he or she has obtained the principal evidence for the opinion will be qualitative as well as quantitative. For example, the auditor might give more weight to work he or she performed on pervasive controls and in areas such as the control environment than on other controls, such as controls over low-risk, routine transactions.

109. The auditor should evaluate whether to use the work performed by others in the audit of internal control over financial reporting. To determine the extent to which the auditor may use the work of others to alter the nature, timing, or extent of the work the auditor would have otherwise performed, in addition to obtaining the principal evidence for his or her opinion, the auditor should:

a. Evaluate the nature of the controls subjected to the work of others (See paragraphs 112 through 116);

b. Evaluate the competence and objectivity of the individuals who performed the work (See paragraphs 117 through 122); and

c. Test some of the work performed by others to evaluate the quality and effectiveness of their work (See paragraphs 123 through 125).

> Note: AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, applies to using the work of internal auditors in an audit of the financial statements. The auditor may apply the relevant concepts described in that section to using the work of others in the audit of internal control over financial reporting.

110. The auditor must obtain sufficient evidence to support his or her opinion. Judgments about the sufficiency of evidence obtained and other factors affecting the auditor's opinion, such as the significance of identified control deficiencies, should be those of the auditor. Evidence obtained through the auditor's direct

personal knowledge, observation, reperformance, and inspection is generally more persuasive than information obtained indirectly from others, such as from internal auditors, other company personnel, or third parties working under the direction of management.

111. The requirement that the auditor's own work must provide the principal evidence for the auditor's opinion is one of the boundaries within which the auditor determines the work he or she must perform himself or herself in the audit of internal control over financial reporting. Paragraphs 112 through 125 provide more specific and definitive direction on how the auditor makes this determination, but the directions allow the auditor significant flexibility to use his or her judgment to determine the work necessary to obtain the principal evidence and to determine when the auditor can use the work of others rather than perform the work himself or herself. Regardless of the auditor's determination of the work that he or she must perform himself or herself, the auditor's responsibility to report on the effectiveness of internal control over financial reporting rests solely with the auditor; this responsibility cannot be shared with the other individuals whose work the auditor uses. Therefore, when the auditor uses the work of others, the auditor is responsible for the results of their work.

112. *Evaluating the Nature of the Controls Subjected to the Work of Others*. The auditor should evaluate the following factors when evaluating the nature of the controls subjected to the work of others. As these factors increase in significance, the need for the auditor to perform his or her own work on those controls increases. As these factors decrease in significance, the need for the auditor to perform his or her own work on those controls decreases.

- The materiality of the accounts and disclosures that the control addresses and the risk of material misstatement.

- The degree of judgment required to evaluate the operating effectiveness of the control (that is, the degree to which the evaluation of the effectiveness of the control requires evaluation of subjective factors rather than objective testing).

- The pervasiveness of the control.

- The level of judgment or estimation required in the account or disclosure.

- The potential for management override of the control.

113. Because of the nature of the controls in the control environment, the auditor should not use the work of others to reduce the amount of work he or she performs on controls in the control environment. The auditor should, however,

consider the results of work performed in this area by others because it might indicate the need for the auditor to increase his or her work.

114. The control environment encompasses the following factors:[16/]

- Integrity and ethical values;
- Commitment to competence;
- Board of directors or audit committee participation;
- Management's philosophy and operating style;
- Organizational structure;
- Assignment of authority and responsibility; and
- Human resource policies and procedures.

115. Controls that are part of the control environment include, but are not limited to, controls specifically established to prevent and detect fraud that is at least reasonably possible to result in material misstatement of the financial statements.

Note: The term "reasonably possible" has the same meaning as in FAS No. 5. See the first note to paragraph 9 for further discussion.

116. The auditor should perform the walkthroughs (as discussed beginning at paragraph 79) himself or herself because of the degree of judgment required in performing this work. However, to provide additional evidence, the auditor may also review the work of others who have performed and documented walkthroughs. In evaluating whether his or her own evidence provides the principal evidence, the auditor's work on the control environment and in performing walkthroughs constitutes an important part of the auditor's own work.

117. *Evaluating the Competence and Objectivity of Others*. The extent to which the auditor may use the work of others depends on the degree of competence and objectivity of the individuals performing the work. The higher the degree of competence and objectivity, the greater use the auditor may make of the work; conversely, the lower the degree of competence and objectivity, the less use the auditor may make of the work. Further, the auditor should not use the work of individuals who have a low degree of objectivity, regardless of their

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[16/] See the COSO report and paragraph .110 of AU sec. 319, *Internal Control in a Financial Statement Audit*, for additional information about the factors included in the control environment.

level of competence. Likewise, the auditor should not use the work of individuals who have a low level of competence regardless of their degree of objectivity.

118. When evaluating the competence and objectivity of the individuals performing the tests of controls, the auditor should obtain, or update information from prior years, about the factors indicated in the following paragraph. The auditor should determine whether to test the existence and quality of those factors and, if so, the extent to which to test the existence and quality of those factors, based on the intended effect of the work of others on the audit of internal control over financial reporting.

119. Factors concerning the competence of the individuals performing the tests of controls include:

- Their educational level and professional experience.
- Their professional certification and continuing education.
- Practices regarding the assignment of individuals to work areas.
- Supervision and review of their activities.
- Quality of the documentation of their work, including any reports or recommendations issued.
- Evaluation of their performance.

120. Factors concerning the objectivity of the individuals performing the tests of controls include:

- The organizational status of the individuals responsible for the work of others ("testing authority") in testing controls, including—

    a. Whether the testing authority reports to an officer of sufficient status to ensure sufficient testing coverage and adequate consideration of, and action on, the findings and recommendations of the individuals performing the testing.

    b. Whether the testing authority has direct access and reports regularly to the board of directors or the audit committee.

    c. Whether the board of directors or the audit committee oversees employment decisions related to the testing authority.

- Policies to maintain the individuals' objectivity about the areas being tested, including—

  a. Policies prohibiting individuals from testing controls in areas in which relatives are employed in important or internal control-sensitive positions.

  b. Policies prohibiting individuals from testing controls in areas to which they were recently assigned or are scheduled to be assigned upon completion of their controls testing responsibilities.

121. Internal auditors normally are expected to have greater competence with regard to internal control over financial reporting and objectivity than other company personnel. Therefore, the auditor may be able to use their work to a greater extent than the work of other company personnel. This is particularly true in the case of internal auditors who follow the *International Standards for the Professional Practice of Internal Auditing* issued by the Institute of Internal Auditors. If internal auditors have performed an extensive amount of relevant work and the auditor determines they possess a high degree of competence and objectivity, the auditor could use their work to the greatest extent an auditor could use the work of others. On the other hand, if the internal audit function reports solely to management, which would reduce internal auditors' objectivity, or if limited resources allocated to the internal audit function result in very limited testing procedures on its part or reduced competency of the internal auditors, the auditor should use their work to a much lesser extent and perform more of the testing himself or herself.

122. When determining how the work of others will alter the nature, timing, or extent of the auditor's work, the auditor should assess the interrelationship of the nature of the controls, as discussed in paragraph 112, and the competence and objectivity of those who performed the work, as discussed in paragraphs 117 through 121. As the significance of the factors listed in paragraph 112 increases, the ability of the auditor to use the work of others decreases at the same time that the necessary level of competence and objectivity of those who perform the work increases. For example, for some pervasive controls, the auditor may determine that using the work of internal auditors to a limited degree would be appropriate and that using the work of other company personnel would not be appropriate because other company personnel do not have a high enough degree of objectivity as it relates to the nature of the controls.

123. *Testing the Work of Others*. The auditor should test some of the work of others to evaluate the quality and effectiveness of the work. The auditor's tests of the work of others may be accomplished by either (a) testing some of the controls that others tested or (b) testing similar controls not actually tested by others.

124. The nature and extent of these tests depend on the effect of the work of others on the auditor's procedures but should be sufficient to enable the auditor to make an evaluation of the overall quality and effectiveness of the work the auditor is considering. The auditor also should assess whether this evaluation has an effect on his or her conclusions about the competence and objectivity of the individuals performing the work.

125. In evaluating the quality and effectiveness of the work of others, the auditor should evaluate such factors as to whether the:

- Scope of work is appropriate to meet the objectives.
- Work programs are adequate.
- Work performed is adequately documented, including evidence of supervision and review.
- Conclusions are appropriate in the circumstances.
- Reports are consistent with the results of the work performed.

126. The following examples illustrate how to apply the directions discussed in this section:

- *Controls over the period-end financial reporting process*. Many of the controls over the period-end financial reporting process address significant risks of misstatement of the accounts and disclosures in the annual and quarterly financial statements, may require significant judgment to evaluate their operating effectiveness, may have a higher potential for management override, and may affect accounts that require a high level of judgment or estimation. Therefore, the auditor could determine that, based on the nature of controls over the period-end financial reporting process, he or she would need to perform more of the tests of those controls himself or herself. Further, because of the nature of the controls, the auditor should use the work of others only if the degree of competence and objectivity of the individuals performing the work is high; therefore, the auditor might use the work of internal auditors to some extent but not the work of others within the company.

- *Information technology general controls*. Information technology general controls are part of the control activities component of internal control; therefore, the nature of the controls might permit the auditor to use the work of others. For example, program change controls over routine maintenance changes may have a highly pervasive effect, yet involve a low degree of judgment in evaluating their operating effectiveness, can be subjected to objective testing, and have a low potential for management override. Therefore, the auditor could determine that, based on the nature of these program change controls, the auditor could use the work of others to a moderate extent so long as the degree of competence and objectivity of the individuals performing the test is at an appropriate level. On the other hand, controls to detect attempts to override controls that prevent unauthorized journal entries from being posted may have a highly pervasive effect, may involve a high degree of judgment in evaluating their operating effectiveness, may involve a subjective evaluation, and may have a reasonable possibility for management override. Therefore, the auditor could determine that, based on the nature of these controls over systems access, he or she would need to perform more of the tests of those controls himself or herself. Further, because of the nature of the controls, the auditor should use the work of others only if the degree of competence and objectivity of the individuals performing the tests is high.

- *Management self-assessment of controls*. As described in paragraph 40, management may test the operating effectiveness of controls using a self-assessment process. Because such an assessment is made by the same personnel who are responsible for performing the control, the individuals performing the self-assessment do not have sufficient objectivity as it relates to the subject matter. Therefore, the auditor should not use their work.

- *Controls over the calculation of depreciation of fixed assets*. Controls over the calculation of depreciation of fixed assets are usually not pervasive, involve a low degree of judgment in evaluating their operating effectiveness, and can be subjected to objective testing. If these conditions describe the controls over the calculation of depreciation of fixed assets and if there is a low potential for management override, the auditor could determine that, based on the nature of these controls, the auditor could use the work of others to a large extent (perhaps entirely) so long as the degree of competence and objectivity of the individuals performing the test is at an appropriate level.

- *Alternating tests of controls*. Many of the controls over accounts payable, including controls over cash disbursements, are usually not pervasive, involve a low degree of judgment in evaluating their operating effectiveness, can be subjected to objective testing, and have a low potential for management override. When these conditions describe the controls over accounts payable, the auditor could determine that, based on the nature of these controls, he or she could use the work of others to a large extent (perhaps entirely) so long as the degree of competence and objectivity of the individuals performing the test is at an appropriate level. However, if the company recently implemented a major information technology change that significantly affected controls over cash disbursements, the auditor might decide to use the work of others to a lesser extent in the audit immediately following the information technology change and then return, in subsequent years, to using the work of others to a large extent in this area. As another example, the auditor might use the work of others for testing controls over the depreciation of fixed assets (as described in the point above) for several years' audits but decide one year to perform some extent of the work himself or herself to gain an understanding of these controls beyond that provided by performing a walkthrough.

Forming an Opinion on the Effectiveness of Internal Control Over Financial Reporting

127. When forming an opinion on internal control over financial reporting, the auditor should evaluate all evidence obtained from all sources, including:

- The adequacy of the assessment performed by management and the results of the auditor's evaluation of the design and tests of operating effectiveness of controls;

- The negative results of substantive procedures performed during the financial statement audit (for example, recorded and unrecorded adjustments identified as a result of the performance of the auditing procedures); and

- Any identified control deficiencies.

128. As part of this evaluation, the auditor should review all reports issued during the year by internal audit (or similar functions, such as loan review in a financial institution) that address controls related to internal control over financial reporting and evaluate any control deficiencies identified in those reports. This review should include reports issued by internal audit as a result of operational audits or specific reviews of key processes if those reports address controls related to internal control over financial reporting.

129. *Issuing an Unqualified Opinion*. The auditor may issue an unqualified opinion only when there are no identified material weaknesses and when there have been no restrictions on the scope of the auditor's work. The existence of a material weakness requires the auditor to express an adverse opinion on the

effectiveness of internal control over financial reporting (See paragraph 175), while a scope limitation requires the auditor to express a qualified opinion or a disclaimer of opinion, depending on the significance of the limitation in scope (See paragraph 178).

130. *Evaluating Deficiencies in Internal Control Over Financial Reporting*. The auditor must evaluate identified control deficiencies and determine whether the deficiencies, individually or in combination, are significant deficiencies or material weaknesses. The evaluation of the significance of a deficiency should include both quantitative and qualitative factors.

131. The auditor should evaluate the significance of a deficiency in internal control over financial reporting initially by determining the following:

- The likelihood that a deficiency, or a combination of deficiencies, could result in a misstatement of an account balance or disclosure; and

- The magnitude of the potential misstatement resulting from the deficiency or deficiencies.

132. The significance of a deficiency in internal control over financial reporting depends on the *potential* for a misstatement, not on whether a misstatement actually has occurred.

133. Several factors affect the *likelihood* that a deficiency, or a combination of deficiencies, could result in a misstatement of an account balance or disclosure. The factors include, but are not limited to, the following:

- The nature of the financial statement accounts, disclosures, and assertions involved; for example, suspense accounts and related party transactions involve greater risk.

- The susceptibility of the related assets or liability to loss or fraud; that is, greater susceptibility increases risk.

- The subjectivity, complexity, or extent of judgment required to determine the amount involved; that is, greater subjectivity, complexity, or judgment, like that related to an accounting estimate, increases risk.

- The cause and frequency of known or detected exceptions for the operating effectiveness of a control; for example, a control with an observed non-negligible deviation rate is a deficiency.

- The interaction or relationship of the control with other controls; that is, the interdependence or redundancy of the control.

- The interaction of the deficiencies; for example, when evaluating a combination of two or more deficiencies, whether the deficiencies could affect the same financial statement accounts and assertions.

- The possible future consequences of the deficiency.

134. When evaluating the likelihood that a deficiency or combination of deficiencies could result in a misstatement, the auditor should evaluate how the controls interact with other controls. There are controls, such as information technology general controls, on which other controls depend. Some controls function together as a group of controls. Other controls overlap, in the sense that these other controls achieve the same objective.

135. Several factors affect the magnitude of the misstatement that could result from a deficiency or deficiencies in controls. The factors include, but are not limited to, the following:

- The financial statement amounts or total of transactions exposed to the deficiency.

- The volume of activity in the account balance or class of transactions exposed to the deficiency that has occurred in the current period or that is expected in future periods.

136. In evaluating the magnitude of the potential misstatement, the auditor should recognize that the maximum amount that an account balance or total of transactions can be overstated is generally the recorded amount. However, the recorded amount is not a limitation on the amount of potential understatement. The auditor also should recognize that the risk of misstatement might be different for the maximum possible misstatement than for lesser possible amounts.

137. When evaluating the significance of a deficiency in internal control over financial reporting, the auditor also should determine the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles. If the auditor determines that the deficiency would prevent prudent officials in the conduct of their own affairs from concluding that they have reasonable assurance,[17/] then the auditor should deem

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[17/] See SEC Staff Accounting Bulletin Topic 1M2, *Immaterial Misstatements That Are Intentional*, for further discussion about the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs.

the deficiency to be at least a significant deficiency. Having determined in this manner that a deficiency represents a significant deficiency, the auditor must further evaluate the deficiency to determine whether individually, or in combination with other deficiencies, the deficiency is a material weakness.

Note: Paragraphs 9 and 10 provide the definitions of significant deficiency and material weakness, respectively.

138. Inadequate documentation of the design of controls and the absence of sufficient documented evidence to support management's assessment of the operating effectiveness of internal control over financial reporting are control deficiencies. As with other control deficiencies, the auditor should evaluate these deficiencies as to their significance.

139. The interaction of qualitative considerations that affect internal control over financial reporting with quantitative considerations ordinarily results in deficiencies in the following areas being at least significant deficiencies in internal control over financial reporting:

- Controls over the selection and application of accounting policies that are in conformity with generally accepted accounting principles;
- Antifraud programs and controls;
- Controls over non-routine and non-systematic transactions; and
- Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; initiate, authorize, record, and process journal entries into the general ledger; and record recurring and nonrecurring adjustments to the financial statements

140. Each of the following circumstances should be regarded as at least a significant deficiency and as a strong indicator that a material weakness in internal control over financial reporting exists:

- Restatement of previously issued financial statements to reflect the correction of a misstatement.

  Note: The correction of a misstatement includes misstatements due to error or fraud; it does not include restatements to reflect a change in accounting principle to comply with a new accounting principle or a voluntary change from one generally accepted accounting principle to another generally accepted accounting principle.

- Identification by the auditor of a material misstatement in financial statements in the current period that was not initially identified by the company's internal control over financial reporting. (This is a strong indicator of a material weakness even if management subsequently corrects the misstatement.)

- Oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective. (Paragraphs 55 through 59 present factors to evaluate when determining whether the audit committee is ineffective.)

- The internal audit function or the risk assessment function is ineffective at a company for which such a function needs to be effective for the company to have an effective monitoring or risk assessment component, such as for very large or highly complex companies.

  Note: The evaluation of the internal audit or risk assessment functions is similar to the evaluation of the audit committee, as described in paragraphs 55 through 59, that is, the evaluation is made within the context of the monitoring and risk assessment components. The auditor is not required to make a separate evaluation of the effectiveness and performance of these functions. Instead, the auditor should base his or her evaluation on evidence obtained as part of evaluating the monitoring and risk assessment components of internal control over financial reporting.

- For complex entities in highly regulated industries, an ineffective regulatory compliance function. This relates solely to those aspects of the ineffective regulatory compliance function in which associated violations of laws and regulations could have a material effect on the reliability of financial reporting.

- Identification of fraud of any magnitude on the part of senior management.

  Note: The auditor is required to plan and perform procedures to obtain reasonable assurance that material misstatement caused by fraud is detected by the auditor. However, for the purposes of evaluating and reporting deficiencies in internal control over financial reporting, the auditor should evaluate fraud of any magnitude (including fraud resulting in immaterial misstatements) on the part of senior management of which he or she is aware. Furthermore, for the purposes of this circumstance, "senior management" includes the principal executive and financial officers signing the company's certifications as required under Section 302 of the Act as well as any other member of management who play a significant role in the company's financial reporting process.

- Significant deficiencies that have been communicated to management and the audit committee remain uncorrected after some reasonable period of time.

- An ineffective control environment.

141. Appendix D provides examples of significant deficiencies and material weaknesses.

Requirement for Written Representations

142. In an audit of internal control over financial reporting, the auditor should obtain written representations from management:

a. Acknowledging management's responsibility for establishing and maintaining effective internal control over financial reporting;

b. Stating that management has performed an assessment of the effectiveness of the company's internal control over financial reporting and specifying the control criteria;

c. Stating that management did not use the auditor's procedures performed during the audits of internal control over financial reporting or the financial statements as part of the basis for management's assessment of the effectiveness of internal control over financial reporting;

d. Stating management's conclusion about the effectiveness of the company's internal control over financial reporting based on the control criteria as of a specified date;

e. Stating that management has disclosed to the auditor all deficiencies in the design or operation of internal control over financial reporting identified as part of management's assessment, including separately disclosing to the auditor all such deficiencies that it believes to be significant deficiencies or material weaknesses in internal control over financial reporting;

f. Describing any material fraud and any other fraud that, although not material, involves senior management or management or other employees who have a significant role in the company's internal control over financial reporting;

g. Stating whether control deficiencies identified and communicated to the audit committee during previous engagements pursuant to paragraph 207 have been resolved, and specifically identifying any that have not; and

h. Stating whether there were, subsequent to the date being reported on, any changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses.

143. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion. As discussed further in paragraph 178, when management limits the scope of the audit, the auditor should either withdraw from the engagement or disclaim an opinion. Further, the auditor should evaluate the effects of management's refusal on his or her ability to rely on other representations, including, if applicable, representations obtained in an audit of the company's financial statements.

144. AU sec. 333, *Management Representations*, explains matters such as who should sign the letter, the period to be covered by the letter, and when to obtain an updating letter.

Relationship of an Audit of Internal Control over Financial Reporting to an Audit of Financial Statements

145. The audit of internal control over financial reporting should be integrated with the audit of the financial statements. The objectives of the procedures for the audits are not identical, however, and the auditor must plan and perform the work to achieve the objectives of both audits.

146. The understanding of internal control over financial reporting the auditor obtains and the procedures the auditor performs for purposes of expressing an opinion on management's assessment are interrelated with the internal control over financial reporting understanding the auditor obtains and procedures the auditor performs to assess control risk for purposes of expressing an opinion on the financial statements. As a result, it is efficient for the auditor to coordinate obtaining the understanding and performing the procedures.

Tests of Controls in an Audit of Internal Control Over Financial Reporting

147. The objective of the tests of controls in an audit of internal control over financial reporting is to obtain evidence about the effectiveness of controls to support the auditor's opinion on whether management's assessment of the effectiveness of the company's internal control over financial reporting is fairly

stated. The auditor's opinion relates to the effectiveness of the company's internal control over financial reporting as of a *point in time* and *taken as a whole*.

148. To express an opinion on internal control over financial reporting effectiveness as of a *point in time*, the auditor should obtain evidence that internal control over financial reporting has operated effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the company's financial statements. To express an opinion on internal control over financial reporting effectiveness *taken as a whole*, the auditor must obtain evidence about the effectiveness of controls over all relevant assertions related to all significant accounts and disclosures in the financial statements. This requires that the auditor test the design and operating effectiveness of controls he or she ordinarily would not test if expressing an opinion only on the financial statements.

149. When concluding on the effectiveness of internal control over financial reporting for purposes of expressing an opinion on management's assessment, the auditor should incorporate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the financial statements, as discussed in the following section.

Tests of Controls in an Audit of Financial Statements

150. To express an opinion on the financial statements, the auditor ordinarily performs tests of controls and substantive procedures. The objective of the tests of controls the auditor performs for this purpose is to assess control risk. To assess control risk for specific financial statement assertions at less than the maximum, the auditor is required to obtain evidence that the relevant controls operated effectively during the *entire period* upon which the auditor plans to place reliance on those controls. However, the auditor is not required to assess control risk at less than the maximum for *all* relevant assertions and, for a variety of reasons, the auditor may choose not to do so.[18/]

151. When concluding on the effectiveness of controls for the purpose of assessing control risk, the auditor also should evaluate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on management's assessment, as discussed in paragraphs 147 through 149. Consideration of these results may require the auditor to alter the nature, timing, and extent of substantive procedures and to plan and perform further tests of controls, particularly in response to identified control deficiencies.

[18/] See paragraph 160 for additional documentation requirements when the auditor assesses control risk as other than low.

Effect of Tests of Controls on Substantive Procedures

152. Regardless of the assessed level of control risk or the assessed risk of material misstatement in connection with the audit of the financial statements, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures. Performing procedures to express an opinion on internal control over financial reporting does not diminish this requirement.

153. The substantive procedures that the auditor should perform consist of tests of details of transactions and balances and analytical procedures. Before using the results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information. For significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.

154. When designing substantive analytical procedures, the auditor also should evaluate the risk of management override of controls. As part of this process, the auditor should evaluate whether such an override might have allowed adjustments outside of the normal period-end financial reporting process to have been made to the financial statements. Such adjustments might have resulted in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions. For this reason, substantive analytical procedures alone are not well suited to detecting fraud.

155. The auditor's substantive procedures must include reconciling the financial statements to the accounting records. The auditor's substantive procedures also should include examining material adjustments made during the course of preparing the financial statements. Also, other auditing standards require auditors to perform specific tests of details in the financial statement audit. For instance, AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to perform certain tests of details to further address the risk of management override, whether or not a specific risk of fraud has been identified. Paragraph .34 of AU Sec. 330, *The Confirmation Process*, states that there is a presumption that the auditor will request the confirmation of accounts receivable. Similarly, paragraph .01 of AU Sec. 331, *Inventories*, states that observation of inventories is a generally accepted auditing procedure and that the auditor who issues an opinion without this procedure "has the burden of justifying the opinion expressed."

156. If, during the audit of internal control over financial reporting, the auditor identifies a control deficiency, he or she should determine the effect on the nature, timing, and extent of substantive procedures to be performed to reduce

the risk of material misstatement of the financial statements to an appropriately low level.

Effect of Substantive Procedures on the Auditor's Conclusions About the Operating Effectiveness of Controls

157. In an audit of internal control over financial reporting, the auditor should evaluate the effect of the findings of all substantive auditing procedures performed in the audit of financial statements on the effectiveness of internal control over financial reporting. This evaluation should include, but not be limited to:

- The auditor's risk evaluations in connection with the selection and application of substantive procedures, especially those related to fraud (See paragraph 26);
- Findings with respect to illegal acts and related party transactions;
- Indications of management bias in making accounting estimates and in selecting accounting principles; and
- Misstatements detected by substantive procedures. The extent of such misstatements might alter the auditor's judgment about the effectiveness of controls.

158. However, the absence of misstatements detected by substantive procedures does not provide evidence that controls related to the assertion being tested are effective.

Documentation Requirements

159. In addition to the documentation requirements in AU sec. 339, *Audit Documentation*, the auditor should document:

- The understanding obtained and the evaluation of the design of each of the five components of the company's internal control over financial reporting;
- The process used to determine significant accounts and disclosures and major classes of transactions, including the determination of the locations or business units at which to perform testing;
- The identification of the points at which misstatements related to relevant financial statement assertions could occur within significant accounts and disclosures and major classes of transactions;

- The extent to which the auditor relied upon work performed by others as well as the auditor's assessment of their competence and objectivity;

- The evaluation of any deficiencies noted as a result of the auditor's testing; and

- Other findings that could result in a modification to the auditor's report.

160. For a company that has effective internal control over financial reporting, the auditor ordinarily will be able to perform sufficient testing of controls to be able to assess control risk for all relevant assertions related to significant accounts and disclosures at a low level. If, however, the auditor assesses control risk as other than low for certain assertions or significant accounts, the auditor should document the reasons for that conclusion. Examples of when it is appropriate to assess control risk as other than low include:

- When a control over a relevant assertion related to a significant account or disclosure was superseded late in the year and only the new control was tested for operating effectiveness.

- When a material weakness existed during the period under audit and was corrected by the end of the period.

161. The auditor also should document the effect of a conclusion that control risk is other than low for any relevant assertions related to any significant accounts in connection with the audit of the financial statements on his or her opinion on the audit of internal control over financial reporting.

Reporting on Internal Control Over Financial Reporting

Management's Report

162. Management is required to include in its annual report its assessment of the effectiveness of the company's internal control over financial reporting in addition to its audited financial statements as of the end of the most recent fiscal year. Management's report on internal control over financial reporting is required to include the following:[19/]

[19/] See Item 308(a) of Regulation S-B and S-K, 17 C.F.R. 228.308(a) and 17 C.F.R. 229.308(a), respectively.

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company;

- A statement identifying the framework used by management to conduct the required assessment of the effectiveness of the company's internal control over financial reporting;

- An assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including an explicit statement as to whether that internal control over financial reporting is effective; and

- A statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the company's internal control over financial reporting.

163. Management should provide, both in its report on internal control over financial reporting and in its representation letter to the auditor, a written conclusion about the effectiveness of the company's internal control over financial reporting. The conclusion about the effectiveness of a company's internal control over financial reporting can take many forms; however, management is required to state a direct conclusion about whether the company's internal control over financial reporting is effective. This standard, for example, includes the phrase "management's assessment that W Company maintained effective internal control over financial reporting as of [*date*]" to illustrate such a conclusion. Other phrases, such as "management's assessment that W Company's internal control over financial reporting as of [*date*] is sufficient to meet the stated objectives," also might be used. However, the conclusion should not be so subjective (for example, "very effective internal control") that people having competence in and using the same or similar criteria would not ordinarily be able to arrive at similar conclusions.

164. Management is precluded from concluding that the company's internal control over financial reporting is effective if there are one or more material weaknesses.[20/] In addition, management is required to disclose all material weaknesses that exist as of the end of the most recent fiscal year.

165. Management might be able to accurately represent that internal control over financial reporting, as of the end of the company's most recent fiscal year, is effective even if one or more material weaknesses existed during the period. To

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[20] See Item 308(a)(3) of Regulation S-B and S-K, 17 C.F.R. 228.308(a) and 17 C.F.R. 229.308(a), respectively.

make this representation, management must have changed the internal control over financial reporting to eliminate the material weaknesses sufficiently in advance of the "as of" date and have satisfactorily tested the effectiveness over a period of time that is adequate for it to determine whether, as of the end of the fiscal year, the design and operation of internal control over financial reporting is effective.[21/]

Auditor's Evaluation of Management's Report

166. With respect to management's report on its assessment, the auditor should evaluate the following matters:

a. Whether management has properly stated its responsibility for establishing and maintaining adequate internal control over financial reporting.

b. Whether the framework used by management to conduct the evaluation is suitable. (As discussed in paragraph 14, the framework described in COSO constitutes a suitable and available framework.)

c. Whether management's assessment of the effectiveness of internal control over financial reporting, as of the end of the company's most recent fiscal year, is free of material misstatement.

d. Whether management has expressed its assessment in an acceptable form.

- Management is required to state whether the company's internal control over financial reporting is effective.
- A negative assurance statement indicating that, "Nothing has come to management's attention to suggest that the company's internal control over financial reporting is not effective," is not acceptable.
- Management is not permitted to conclude that the company's internal control over financial reporting is effective if there

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[21] However, when the reason for a change in internal control over financial reporting is the correction of a material weakness, management and the auditor should evaluate whether the reason for the change and the circumstances surrounding the change are material information necessary to make the disclosure about the change not misleading in a filing subject to certification under Securities Exchange Act Rule 13a-14(a) or 15d-14(a), 17 C.F.R. 240.13a-14(a) or 17 C.F.R. 240.15d-14(a). See discussion beginning at paragraph 200 for further direction.

are one or more material weaknesses in the company's internal control over financial reporting.

e. Whether material weaknesses identified in the company's internal control over financial reporting, if any, have been properly disclosed, including material weaknesses corrected during the period.[22/]

Auditor's Report on Management's Assessment of Internal Control Over Financial Reporting

167. The auditor's report on management's assessment of the effectiveness of internal control over financial reporting must include the following elements:

a. A title that includes the word *independent*;

b. An identification of management's conclusion about the effectiveness of the company's internal control over financial reporting as of a specified date based on the control criteria [for example, criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)];

c. An identification of the title of the management report that includes management's assessment (the auditor should use the same description of the company's internal control over financial reporting as management uses in its report);

d. A statement that the assessment is the responsibility of management;

e. A statement that the auditor's responsibility is to express an opinion on the assessment and an opinion on the company's internal control over financial reporting based on his or her audit;

f. A definition of internal control over financial reporting as stated in paragraph 7;

[22/] See paragraph 206 for direction when a material weakness was corrected during the fourth quarter and the auditor believes that modification to the disclosures about changes in internal control over financial reporting are necessary for the annual certifications to be accurate and to comply with the requirements of Section 302 of the Act.

g. A statement that the audit was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States);

h. A statement that the standards of the Public Company Accounting Oversight Board require that the auditor plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects;

i. A statement that an audit includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as the auditor considered necessary in the circumstances;

j. A statement that the auditor believes the audit provides a reasonable basis for his or her opinions;

k. A paragraph stating that, because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate;

l. The auditor's opinion on whether management's assessment of the effectiveness of the company's internal control over financial reporting as of the specified date is fairly stated, in all material respects, based on the control criteria (See discussion beginning at paragraph 162);

m. The auditor's opinion on whether the company maintained, in all material respects, effective internal control over financial reporting as of the specified date, based on the control criteria;

n. The manual or printed signature of the auditor's firm;

o. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued; and

p. The date of the audit report.

168. Example A-1 in Appendix A is an illustrative auditor's report for an unqualified opinion on management's assessment of the effectiveness of the company's internal control over financial reporting and an unqualified opinion on the effectiveness of the company's internal control over financial reporting.

169. *Separate or Combined Reports*. The auditor may choose to issue a combined report (that is, one report containing both an opinion on the financial statements and the opinions on internal control over financial reporting) or separate reports on the company's financial statements and on internal control over financial reporting. Example A-7 in Appendix A is an illustrative combined audit report on internal control over financial reporting. Appendix A also includes examples of separate reports on internal control over financial reporting.

170. If the auditor chooses to issue a separate report on internal control over financial reporting, he or she should add the following paragraph to the auditor's report on the financial statements:

> We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of W Company's internal control over financial reporting as of December 31, 20X3, based on [*identify control criteria*] and our report dated [*date of report, which should be the same as the date of the report on the financial statements*] expressed [*include nature of opinions*].

and add the following paragraph to the report on internal control over financial reporting:

> We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting*] expressed [*include nature of opinion*].

171. *Report Date*. As stated previously, the auditor cannot audit internal control over financial reporting without also auditing the financial statements. Therefore, the reports should be dated the same.

172. When the auditor elects to issue a combined report on the audit of the financial statements and the audit of internal control over financial reporting, the audit opinion will address multiple reporting periods for the financial statements presented but only the end of the most recent fiscal year for the effectiveness of internal control over financial reporting and management's assessment of the effectiveness of internal control over financial reporting. See a combined report in Example A-7 in Appendix A.

173. *Report Modifications*. The auditor should modify the standard report if any of the following conditions exist.

a. Management's assessment is inadequate or management's report is inappropriate. (See paragraph 174.)

b. There is a material weakness in the company's internal control over financial reporting. (See paragraphs 175 through 177.)

c. There is a restriction on the scope of the engagement. (See paragraphs 178 through 181.)

d. The auditor decides to refer to the report of other auditors as the basis, in part, for the auditor's own report. (See paragraphs 182 through 185.)

e. A significant subsequent event has occurred since the date being reported on. (See paragraphs 186 through 189.)

f. There is other information contained in management's report on internal control over financial reporting. (See paragraphs 190 through 192.)

174. *Management's Assessment Inadequate or Report Inappropriate*. If the auditor determines that management's process for assessing internal control over financial reporting is inadequate, the auditor should modify his or her opinion for a scope limitation (discussed further beginning at paragraph 178). If the auditor determines that management's report is inappropriate, the auditor should modify his or her report to include, at a minimum, an explanatory paragraph describing the reasons for this conclusion.

175. *Material Weaknesses*. Paragraphs 130 through 141 describe significant deficiencies and material weaknesses. If there are significant deficiencies that, individually or in combination, result in one or more material weaknesses, management is precluded from concluding that internal control over financial reporting is effective. In these circumstances, the auditor must express an adverse opinion on the company's internal control over financial reporting.

176. When expressing an adverse opinion on the effectiveness of internal control over financial reporting because of a material weakness, the auditor's report must include:

- The definition of a material weakness, as provided in paragraph 10.

- A statement that a material weakness has been identified and included in management's assessment. (If the material weakness has not been included in management's assessment, this sentence should be modified to state that the material weakness has been identified but not included in management's assessment. In this case, the auditor also is required to communicate in writing to the audit committee that the material weakness was not disclosed or identified as a material weakness in management's report.)

- A description of any material weaknesses identified in a company's internal control over financial reporting. This description should provide the users of the audit report with specific information about the nature of any material weakness, and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness. This description also should address requirements described in paragraph 194.

177. Depending on the circumstances, the auditor may express both an unqualified opinion and an other-than-unqualified opinion within the same report on internal control over financial reporting. For example, if management makes an adverse assessment because a material weakness has been identified and not corrected ("…internal control over financial reporting is not effective…"), the auditor would express an unqualified opinion on management's assessment ("…management's assessment that internal control over financial reporting is not effective is fairly stated, in all material respects…"). At the same time, the auditor would express an adverse opinion about the effectiveness of internal control over financial reporting ("In our opinion, because of the effect of the material weakness described…, the company's internal control over financial reporting is not effective."). Example A-2 in Appendix A illustrates the form of the report that is appropriate in this situation. Example A-6 in Appendix A illustrates a report that reflects disagreement between management and the auditor that a material weakness exists.

178. *Scope Limitations*. The auditor can express an unqualified opinion on management's assessment of internal control over financial reporting and an unqualified opinion on the effectiveness of internal control over financial reporting only if the auditor has been able to apply all the procedures necessary in the circumstances. If there are restrictions on the scope of the engagement imposed by the circumstances, the auditor should withdraw from the engagement, disclaim an opinion, or express a qualified opinion. The auditor's decision depends on his or her assessment of the importance of the omitted procedure(s) to his or her ability to form an opinion on management's assessment of internal control over financial reporting and an opinion on the effectiveness of the company's internal control over financial reporting. However, when the restrictions are imposed by management, the auditor should withdraw from the engagement or disclaim an opinion on management's assessment of internal control over financial reporting and the effectiveness of internal control over financial reporting.

179. For example, management might have identified a material weakness in its internal control over financial reporting prior to the date specified in its report and implemented controls to correct it. If management believes that the new controls have been operating for a sufficient period of time to determine that they are both effectively designed and operating, management would be able to include in its assessment its conclusion that internal control over financial reporting is effective as of the date specified. However, if the auditor disagrees with the sufficiency of the time period, he or she would be unable to obtain sufficient evidence that the new controls have been operating effectively for a sufficient period. In that case, the auditor should modify the opinion on the effectiveness of internal control over financial reporting and the opinion on management's assessment of internal control over financial reporting because of a scope limitation.

180. When the auditor plans to disclaim an opinion and the limited procedures performed by the auditor caused the auditor to conclude that a material weakness exists, the auditor's report should include:

- The definition of a material weakness, as provided in paragraph 10.

- A description of any material weaknesses identified in the company's internal control over financial reporting. This description should provide the users of the audit report with specific information about the nature of any material weakness, and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness. This description also should address the requirements in paragraph 194.

181. Example A-3 in Appendix A illustrates the form of report when there is a limitation on the scope of the audit causing the auditor to issue qualified opinions. Example A-4 illustrates the form of report when restrictions on the scope of the audit cause the auditor to disclaim opinions.

182. *Opinions Based, in Part, on the Report of Another Auditor*. When another auditor has audited the financial statements and internal control over financial reporting of one or more subsidiaries, divisions, branches, or components of the company, the auditor should determine whether he or she may serve as the principal auditor and use the work and reports of another auditor as a basis, in part, for his or her opinions. AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, provides direction on the auditor's decision of whether to serve as the principal auditor of the financial statements. If the auditor decides it is appropriate to serve as the principal auditor of the financial statements, then that auditor also should be the principal auditor of the company's internal control over financial reporting. This relationship results from the requirement that an audit of the financial statements must be performed to audit internal control over

financial reporting; only the principal auditor of the financial statements can be the principal auditor of internal control over financial reporting. In this circumstance, the principal auditor of the financial statements needs to participate sufficiently in the audit of internal control over financial reporting to provide a basis for serving as the principal auditor of internal control over financial reporting.

183. When serving as the principal auditor of internal control over financial reporting, the auditor should decide whether to make reference in the report on internal control over financial reporting to the audit of internal control over financial reporting performed by the other auditor. In these circumstances, the auditor's decision is based on factors similar to those of the independent auditor who uses the work and reports of other independent auditors when reporting on a company's financial statements as described in AU sec. 543.

184. The decision about whether to make reference to another auditor in the report on the audit of internal control over financial reporting might differ from the corresponding decision as it relates to the audit of the financial statements. For example, the audit report on the financial statements may make reference to the audit of a significant equity investment performed by another independent auditor, but the report on internal control over financial reporting might not make a similar reference because management's evaluation of internal control over financial reporting ordinarily would not extend to controls at the equity method investee.[23/]

185. When the auditor decides to make reference to the report of the other auditor as a basis, in part, for his or her opinions, the auditor should refer to the report of the other auditor when describing the scope of the audit and when expressing the opinions.

186. *Subsequent Events*. Changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting might occur subsequent to the date as of which internal control over financial reporting is being audited but before the date of the auditor's report. The auditor should inquire of management whether there were any such changes or factors. As described in paragraph 142, the auditor should obtain written representations from management relating to such matters. Additionally, to obtain information about whether changes have occurred that might affect the effectiveness of the company's internal control over financial reporting and, therefore, the auditor's report, the auditor should inquire about and examine, for this subsequent period, the following:

[23/] See Appendix B, paragraph B15, for further discussion of the evaluation of the controls over financial reporting for an equity method investment.

- Relevant internal audit reports (or similar functions, such as loan review in a financial institution) issued during the subsequent period;

- Independent auditor reports (if other than the auditor's) of significant deficiencies or material weaknesses;

- Regulatory agency reports on the company's internal control over financial reporting; and

- Information about the effectiveness of the company's internal control over financial reporting obtained through other engagements.

187. The auditor could inquire about and examine other documents for the subsequent period. Paragraphs .01 through .09 of AU sec. 560, *Subsequent Events*, provides direction on subsequent events for a financial statement audit that also may be helpful to the auditor performing an audit of internal control over financial reporting.

188. If the auditor obtains knowledge about subsequent events that materially and adversely affect the effectiveness of the company's internal control over financial reporting as of the date specified in the assessment, the auditor should issue an adverse opinion on the effectiveness of internal control over financial reporting (and issue an adverse opinion on management's assessment of internal control over financial reporting if management's report does not appropriately assess the affect of the subsequent event). If the auditor is unable to determine the effect of the subsequent event on the effectiveness of the company's internal control over financial reporting, the auditor should disclaim opinions. As described in paragraph 190, the auditor should disclaim an opinion on management's disclosures about corrective actions taken by the company after the date of management's assessment, if any.

189. The auditor may obtain knowledge about subsequent events with respect to conditions that did not exist at the date specified in the assessment but arose subsequent to that date. If a subsequent event of this type has a material effect on the company, the auditor should include in his or her report an explanatory paragraph describing the event and its effects or directing the reader's attention to the event and its effects as disclosed in management's report. Management's consideration of such events to be disclosed in its report should be limited to a change that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

190. *Management's Report Containing Additional Information*. Management's report on internal control over financial reporting may contain information in

addition to management's assessment of the effectiveness of its internal control over financial reporting. Such information might include, for example:

- Disclosures about corrective actions taken by the company after the date of management's assessment;
- The company's plans to implement new controls; and
- A statement that management believes the cost of correcting a material weakness would exceed the benefits to be derived from implementing new controls.

191. If management's assessment includes such additional information, the auditor should disclaim an opinion on the information. For example, the auditor should use the following language as the last paragraph of the report to disclaim an opinion on management's cost-benefit statement:

> We do not express an opinion or any other form of assurance on management's statement referring to the costs and related benefits of implementing new controls.

192. If the auditor believes that management's additional information contains a material misstatement of fact, he or she should discuss the matter with management. If the auditor concludes that there is a valid basis for concern, he or she should propose that management consult with some other party whose advice might be useful, such as the company's legal counsel. If, after discussing the matter with management and those management has consulted, the auditor concludes that a material misstatement of fact remains, the auditor should notify management and the audit committee, in writing, of the auditor's views concerning the information. The auditor also should consider consulting the auditor's legal counsel about further actions to be taken, including the auditor's responsibility under Section 10A of the Securities Exchange Act of 1934.[24/]

> Note: If management makes the types of disclosures described in paragraph 190 outside its report on internal control over financial reporting and includes them elsewhere within its annual report on the company's financial statements, the auditor would not need to disclaim an opinion, as described in paragraph 191. However, in that situation, the auditor's responsibilities are the same as those described in paragraph 192 if the auditor believes that the additional information contains a material misstatement of fact.

193. *Effect of Auditor's Adverse Opinion on Internal Control Over Financial Reporting on the Opinion on Financial Statements*. In some cases, the auditor's

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[24/] See Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. 78j-1.

report on internal control over financial reporting might describe a material weakness that resulted in an adverse opinion on the effectiveness of internal control over financial reporting while the audit report on the financial statements remains unqualified. Consequently, during the audit of the financial statements, the auditor did not rely on that control. However, he or she performed additional substantive procedures to determine whether there was a material misstatement in the account related to the control. If, as a result of these procedures, the auditor determines that there was not a material misstatement in the account, he or she would be able to express an unqualified opinion on the financial statements.

194. When the auditor's opinion on the financial statements is unaffected by the adverse opinion on the effectiveness of internal control over financial reporting, the report on internal control over financial reporting (or the combined report, if a combined report is issued) should include the following or similar language in the paragraph that describes the material weakness:

> This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 20X3 financial statements, and this report does not affect our report dated [*date of report*] on those financial statements. [*Revise this wording appropriately for use in a combined report*.]

195. Such disclosure is important to ensure that users of the auditor's report on the financial statements understand why the auditor issued an unqualified opinion on those statements.

196. Disclosure is also important when the auditor's opinion on the financial statements is affected by the adverse opinion on the effectiveness of internal control over financial reporting. In that circumstance, the report on internal control over financial reporting (or the combined report, if a combined report is issued) should include the following or similar language in the paragraph that describes the material weakness:

> This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 20X3 financial statements.

197. *Subsequent Discovery of Information Existing at the Date of the Auditor's Report on Internal Control Over Financial Reporting*. After the issuance of the report on internal control over financial reporting, the auditor may become aware of conditions that existed at the report date that might have affected the auditor's opinions had he or she been aware of them. The auditor's evaluation of such subsequent information is similar to the auditor's evaluation of information discovered subsequent to the date of the report on an audit of financial statements, as described in AU sec. 561, *Subsequent Discovery of Facts*

Existing at the Date of the Auditor's Report. That standard requires the auditor to determine whether the information is reliable and whether the facts existed at the date of his or her report. If so, the auditor should determine (1) whether the facts would have changed the report if he or she had been aware of them and (2) whether there are persons currently relying on or likely to rely on the auditor's report. For instance, if previously issued financial statements and the auditor's report have been recalled and reissued to reflect the correction of a misstatement, the auditor should presume that his or her report on the company's internal control over financial reporting as of same specified date also should be recalled and reissued to reflect the material weakness that existed at that date. Based on these considerations, paragraph .06 of AU sec. 561 provides detailed requirements for the auditor.

198. *Filings Under Federal Securities Statutes*. AU sec. 711, *Filings Under Federal Securities Statutes*, describes the auditor's responsibilities when an auditor's report is included in registration statements, proxy statements, or periodic reports filed under the federal securities statutes. The auditor should also apply AU sec. 711 with respect to the auditor's report on management's assessment of the effectiveness of internal control over financial reporting included in such filings. In addition, the direction in paragraph .10 of AU sec. 711 to inquire of and obtain written representations from officers and other executives responsible for financial and accounting matters about whether any events have occurred that have a material effect on the audited financial statements should be extended to matters that could have a material effect on management's assessment of internal control over financial reporting.

199. When the auditor has fulfilled these responsibilities and intends to consent to the inclusion of his or her report on management's assessment of the effectiveness of internal control over financial reporting in the securities filing, the auditor's consent should clearly indicate that both the audit report on financial statements and the audit report on management's assessment of the effectiveness of internal control over financial reporting (or both opinions if a combined report is issued) are included in his or her consent.

Auditor's Responsibilities for Evaluating Management's Certification Disclosures About Internal Control Over Financial Reporting

Required Management Certifications

200. Section 302 of the Act, and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies,[25/] requires a company's management, with the participation of the principal executive and financial officers (the certifying

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[25/] See 17 C.F.R., 240.13a-14a or 15d-14a, whichever applies.

officers), to make the following quarterly and annual certifications with respect to the company's internal control over financial reporting:

- A statement that the certifying officers are responsible for establishing and maintaining internal control over financial reporting;

- A statement that the certifying officers have designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under their supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles; and

- A statement that the report discloses any changes in the company's internal control over financial reporting that occurred during the most recent fiscal quarter (the company's fourth fiscal quarter in the case of an annual report) that have materially affected, or are reasonably likely to materially affect, the company's internal control over financial reporting.

201. When the reason for a change in internal control over financial reporting is the correction of a material weakness, management has a responsibility to determine and the auditor should evaluate whether the reason for the change and the circumstances surrounding that change are material information necessary to make the disclosure about the change not misleading.[26/]

Auditor Evaluation Responsibilities

202. The auditor's responsibility as it relates to management's quarterly certifications on internal control over financial reporting is different from the auditor's responsibility as it relates to management's annual assessment of internal control over financial reporting. The auditor should perform limited procedures quarterly to provide a basis for determining whether he or she has become aware of any material modifications that, in the auditor's judgment, should be made to the disclosures about changes in internal control over financial reporting in order for the certifications to be accurate and to comply with the requirements of Section 302 of the Act.

203. To fulfill this responsibility, the auditor should perform, on a quarterly basis, the following procedures:

26/ See Securities Exchange Act Rule 12b-20, 17 C.F.R. 240.12b-20.

- Inquire of management about significant changes in the design or operation of internal control over financial reporting as it relates to the preparation of annual as well as interim financial information that could have occurred subsequent to the preceding annual audit or prior review of interim financial information;

- Evaluate the implications of misstatements identified by the auditor as part of the auditor's required review of interim financial information (See AU sec. 722, *Interim Financial Information*) as it relates to effective internal control over financial reporting; and

- Determine, through a combination of observation and inquiry, whether any change in internal control over financial reporting has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

Note: Foreign private issuers filing Forms 20-F and 40-F are not subject to quarterly reporting requirements, therefore, the auditor's responsibilities would extend only to the certifications in the annual report of these companies.

204. When matters come to auditor's attention that lead him or her to believe that modification to the disclosures about changes in internal control over financial reporting is necessary for the certifications to be accurate and to comply with the requirements of Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies,[27/] the auditor should communicate the matter(s) to the appropriate level of management as soon as practicable.

205. If, in the auditor's judgment, management does not respond appropriately to the auditor's communication within a reasonable period of time, the auditor should inform the audit committee. If, in the auditor's judgment, the audit committee does not respond appropriately to the auditor's communication within a reasonable period of time, the auditor should evaluate whether to resign from the engagement. The auditor should evaluate whether to consult with his or her attorney when making these evaluations. In these circumstances, the auditor also has responsibilities under AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934.[28/] The auditor's responsibilities for evaluating the disclosures about changes in internal control over financial reporting do not diminish in any way management's responsibility for ensuring

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[27/] See 17 C.F.R. 240.13a-14(a) or 17 C.F.R. 240.15d-14(a), whichever applies.

[28/] See 15 U.S.C. 78j-1.

that its certifications comply with the requirements of Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies.[29/]

206. If matters come to the auditor's attention as a result of the audit of internal control over financial reporting that lead him or her to believe that modifications to the disclosures about changes in internal control over financial reporting (addressing changes in internal control over financial reporting occurring during the fourth quarter) are necessary for the annual certifications to be accurate and to comply with the requirements of Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies,[30/] the auditor should follow the same communication responsibilities as described in paragraphs 204 and 205. However, if management and the audit committee do not respond appropriately, in addition to the responsibilities described in the preceding two paragraphs, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons the auditor believes management's disclosures should be modified.

Required Communications in An Audit of Internal Control Over Financial Reporting

207. The auditor must communicate in writing to management and the audit committee all significant deficiencies and material weaknesses identified during the audit. The written communication should be made prior to the issuance of the auditor's report on internal control over financial reporting. The auditor's communication should distinguish clearly between those matters considered to be significant deficiencies and those considered to be material weaknesses, as defined in paragraphs 9 and 10, respectively.

208. If a significant deficiency or material weakness exists because the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that specific significant deficiency or material weakness in writing to the board of directors.

209. In addition, the auditor should communicate to management, in writing, all deficiencies in internal control over financial reporting (that is, those deficiencies in internal control over financial reporting that are of a lesser magnitude than significant deficiencies) identified during the audit and inform the audit committee when such a communication has been made. When making this communication,

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[29/] See 17 C.F.R. 240.13a-14(a) or 17 C.F.R. 240.15d-14(a), whichever applies.

[30/] See 17 C.F.R. 240.13a-14(a) or 17 C.F.R. 240.15d-14(a), whichever applies.

it is not necessary for the auditor to repeat information about such deficiencies that have been included in previously issued written communications, whether those communications were made by the auditor, internal auditors, or others within the organization. Furthermore, the auditor is not required to perform procedures sufficient to identify all control deficiencies; rather, the auditor should communicate deficiencies in internal control over financial reporting of which he or she is aware.

> Note: As part of his or her evaluation of the effectiveness of internal control over financial reporting, the auditor should determine whether control deficiencies identified by internal auditors and others within the company, for example, through ongoing monitoring activities and the annual assessment of internal control over financial reporting, are reported to appropriate levels of management in a timely manner. The lack of an internal process to report deficiencies in internal control to management on a timely basis represents a control deficiency that the auditor should evaluate as to severity.

210. These written communications should state that the communication is intended solely for the information and use of the board of directors, audit committee, management, and others within the organization. When there are requirements established by governmental authorities to furnish such reports, specific reference to such regulatory agencies may be made.

211. These written communications also should include the definitions of control deficiencies, significant deficiencies, and material weaknesses and should clearly distinguish to which category the deficiencies being communicated relate.

212. Because of the potential for misinterpretation of the limited degree of assurance associated with the auditor issuing a written report representing that no significant deficiencies were noted during an audit of internal control over financial reporting, the auditor should not issue such representations.

213. When auditing internal control over financial reporting, the auditor may become aware of fraud or possible illegal acts. If the matter involves fraud, it must be brought to the attention of the appropriate level of management. If the fraud involves senior management, the auditor must communicate the matter directly to the audit committee as described in AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*. If the matter involves possible illegal acts, the auditor must assure himself or herself that the audit committee is adequately informed, unless the matter is clearly inconsequential, in accordance with AU sec. 317, *Illegal Acts by Clients*. The auditor also must determine his or her responsibilities under Section 10A of the Securities Exchange Act of 1934.[31/]

[31/] See 15 U.S.C. 78j-1.

214. When timely communication is important, the auditor should communicate the preceding matters during the course of the audit rather than at the end of the engagement. The decision about whether to issue an interim communication should be determined based on the relative significance of the matters noted and the urgency of corrective follow-up action required.

Effective Date

215. Companies considered *accelerated filers* under Securities Exchange Act Rule 12b-2[32/] are required to comply with the internal control reporting and disclosure requirements of Section 404 of the Act *for fiscal years ending on or after November 15, 2004*. (Other companies have until fiscal years ending on or after July 15, 2005, to comply with these internal control reporting and disclosure requirements.) Accordingly, independent auditors engaged to audit the financial statements of accelerated filers for fiscal years ending on or after November 15, 2004, also are required to audit and report on the company's internal control over financial reporting as of the end of such fiscal year. This standard is required to be complied with for such engagements, except as it relates to the auditor's responsibilities for evaluating management's certification disclosures about internal control over financial reporting. The auditor's responsibilities for evaluating management's certification disclosures about internal control over financial reporting described in paragraphs 202 through 206 take effect beginning with the first quarter after the auditor's first audit report on the company's internal control over financial reporting.

216. Early compliance with this standard is permitted.

<u>APPENDIX A</u>

Illustrative Reports on Internal Control Over Financial Reporting

A1. Paragraphs 167 through 199 of this standard provide direction on the auditor's report on management's assessment of internal control over financial reporting. The following examples illustrate how to apply that direction in several different situations.

[32/] See 17 C.F.R. 240.12b-2.

ILLUSTRATIVE REPORT
PAGE

Example A-1

ILLUSTRATIVE REPORT EXPRESSING AN UNQUALIFIED OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING AND AN UNQUALIFIED OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING (SEPARATE REPORT)[33/]

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We have audited management's assessment, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

[*Scope paragraph*]

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and

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[33/] If the auditor issues separate reports on the audit of internal control over financial reporting and the audit of the financial statements, both reports should include a statement that the audit was conducted in accordance with standards of the Public Company Accounting Oversight Board (United States).

the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, management's assessment that W Company maintained effective internal control over financial reporting as of December 31, 20X3, is fairly stated, in all material respects, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. Also in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria,* f*or example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Explanatory paragraph*]

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting*] expressed [*include nature of opinion*].

[*Signature*]

[*City and State or Country*]

[*Date*]

Example A-2

ILLUSTRATIVE REPORT EXPRESSING AN UNQUALIFIED OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING AND AN ADVERSE OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING BECAUSE OF THE EXISTENCE OF A MATERIAL WEAKNESS

<u>Report of Independent Registered Public Accounting Firm</u>

[*Introductory paragraph*]

We have audited management's assessment, included in the accompanying [*title of management's report*], that W Company did not maintain effective internal control over financial reporting as of December 31, 20X3, because of the effect of [*material weakness identified in management's assessment*], based on [*Identify criteria,* f*or example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

[*Scope paragraph*]

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Explanatory paragraph*]

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weakness has been identified and included in management's assessment. [*Include a description of the material weakness and its effect on the achievement of the objectives of the control criteria.*] This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 20X3 financial statements, and this report does not affect our report dated [*date of report, which should be the same as the date of this report on internal control*] on those financial statements.[34/]

[*Opinion paragraph*]

In our opinion, management's assessment that W Company did not maintain effective internal control over financial reporting as of December 31, 20X3, is fairly stated, in all material respects, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. Also, in our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, W Company has not maintained effective internal control over financial reporting as

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[34/] Modify this sentence when the auditor's opinion on the financial statements is affected by the adverse opinion on the effectiveness of internal control over financial reporting, as described in paragraph 196.

of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Signature*]

[*City and State or Country*]

[*Date*]

Example A-3

ILLUSTRATIVE REPORT EXPRESSING A QUALIFIED OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING AND A QUALIFIED OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING BECAUSE OF A LIMITATION ON THE SCOPE OF THE AUDIT

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We have audited management's assessment, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria,* f*or example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

[*Scope paragraph*]

Except as described below, we conducted our audit in accordance the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

[*Explanatory paragraph that describes scope limitation*]

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weakness has been identified and included in management's assessment.[35/] Prior to December 20, 20X3, W Company had an inadequate system for recording cash receipts, which could have prevented the Company from recording cash receipts on accounts receivable completely and properly. Therefore, cash received could have been diverted for unauthorized use, lost, or otherwise not properly recorded to accounts receivable. We believe this condition was a material weakness in the design or operation of the internal control of W Company in effect prior to December 20, 20X3. Although the Company implemented a new cash receipts system on December 20, 20X3, the system has not been in operation for a sufficient period of time to enable us to obtain sufficient evidence about its operating effectiveness.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[35/] If the auditor has identified a material weakness that is not included in management's assessment, add the following wording to the report: "In addition, we have identified the following material weakness that has not been identified as a material weakness in management's assessment."

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, except for the effect of matters we might have discovered had we been able to examine evidence about the effectiveness of the new cash receipts system, management's assessment that W Company maintained effective internal control over financial reporting as of December 31, 20X3, is fairly stated, in all material respects, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. Also, in our opinion, except for the effect of matters we might have discovered had we been able to examine evidence about the effectiveness of the new cash receipts system, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Explanatory paragraph*]

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting*] expressed [*include nature of opinion*].

[*Signature*]

[*City and State or Country*]

[*Date*]

Example A-4

ILLUSTRATIVE REPORT DISCLAIMING AN OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING AND DISCLAIMING AN OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING BECAUSE OF A LIMITATION ON THE SCOPE OF THE AUDIT

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We were engaged to audit management's assessment included in the accompanying [*title of management's report*] that W Company maintained effective internal control over financial reporting as of December 31, 20X3 based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting.

[*Omit scope paragraph*]

[*Explanatory paragraph that describes scope limitation*][36/]

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become

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36/ If, through the limited procedures performed, the auditor concludes that a material weakness exists, the auditor should add the definition of material weakness (as provided in paragraph 10) to the explanatory paragraph. In addition, the auditor should include a description of the material weakness and its effect on the achievement of the objectives of the control criteria.

inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

Since management [*describe scope restrictions*] and we were unable to apply other procedures to satisfy ourselves as to the effectiveness of the company's internal control over financial reporting, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion either on management's assessment or on the effectiveness of the company's internal control over financial reporting.

[*Explanatory paragraph*]

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting*] expressed [*include nature of opinion*].

[*Signature*]

[*City and State or Country*]

[*Date*]

Example A-5

ILLUSTRATIVE REPORT EXPRESSING AN UNQUALIFIED OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING THAT REFERS TO THE REPORT OF OTHER AUDITORS AS A BASIS, IN PART, FOR THE AUDITOR'S OPINION AND AN UNQUALIFIED OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING

<u>Report of Independent Registered Public Accounting Firm</u>

[*Introductory paragraph*]

We have audited management's assessment, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit. We did not examine the effectiveness of internal control over financial reporting of B Company, a wholly owned subsidiary, whose financial statements reflect total assets and revenues constituting 20 and 30 percent, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 20X3. The effectiveness of B Company's internal control over financial reporting was audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the effectiveness of B Company's internal control over financial reporting, is based solely on the report of the other auditors.

[*Scope paragraph*]

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit and the report of the other auditors provide a reasonable basis for our opinion.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, based on our audit and the report of the other auditors, management's assessment that W Company maintained effective internal control over financial reporting as of December 31, 20X3, is fairly stated, in all material respects, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. Also, in our opinion, based on our audit and the report of the other auditors, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Explanatory paragraph*]

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting*] expressed [*include nature of opinion*].

[*Signature*]

[*City and State or Country*]

[*Date*]

Example A-6

ILLUSTRATIVE REPORT EXPRESSING AN ADVERSE OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING AND AN ADVERSE OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING BECAUSE OF THE EXISTENCE OF A MATERIAL WEAKNESS

<u>Report of Independent Registered Public Accounting Firm</u>

[*Introductory paragraph*]

We have audited management's assessment, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria,* fo*r example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

[*Scope paragraph*]

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Explanatory paragraph*]

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. We have identified the following material weakness that has not been identified as a material weakness in management's assessment [*Include a description of the material weakness and its effect on the achievement of the objectives of the control criteria.*] This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 20X3 financial statements, and this report does not affect our report dated [*date of report, which should be the same as the date of this report on internal control*] on those financial statements.[37/]

[*Opinion paragraph*]

In our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, management's assessment that W Company maintained effective internal control over financial reporting as of December 31, 20X3, is not fairly stated, in all material respects, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. Also, in our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, W Company has not maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Signature*]

[*City and State or Country*]

[37/] Modify this sentence when the auditor's opinion on the financial statements is affected by the adverse opinion on the effectiveness of internal control over financial reporting.

[*Date*]

Example A-7

ILLUSTRATIVE COMBINED REPORT EXPRESSING AN UNQUALIFIED OPINION ON FINANCIAL STATEMENTS, AN UNQUALIFIED OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING AND AN UNQUALIFIED OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING

<u>Report of Independent Registered Public Accounting Firm</u>

[*Introductory paragraph*]

We have audited the accompanying balance sheets of W Company as of December 31, 20X3 and 20X2, and the related statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 20X3. We also have audited management's assessment, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these financial statements, an opinion on management's assessment, and an opinion on the effectiveness of the company's internal control over financial reporting based on our audits.

[*Scope paragraph*]

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of W Company as of December 31, 20X3 and 20X2, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 20X3 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, management's assessment that W Company maintained effective internal control over financial reporting as of December 31, 20X3, is fairly stated, in all material respects, based on [*Identify control criteria,* f*or example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. Furthermore, in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria,* f*or example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Signature*]

[*City and State or Country*]

[Date]

APPENDIX B

Additional Performance Requirements and Directions; Extent-of-Testing Examples

Tests to be Performed When a Company Has Multiple Locations or Business Units

B1. To determine the locations or business units for performing audit procedures, the auditor should evaluate their relative financial significance and the risk of material misstatement arising from them. In making this evaluation, the auditor should identify the locations or business units that are individually important, evaluate their documentation of controls, and test controls over significant accounts and disclosures. For locations or business units that contain specific risks that, by themselves, could create a material misstatement, the auditor should evaluate their documentation of controls and test controls over the specific risks.

B2. The auditor should determine the other locations or business units that, when aggregated, represent a group with a level of financial significance that could create a material misstatement in the financial statements. For that group, the auditor should determine whether there are company-level controls in place. If so, the auditor should evaluate the documentation and test such company-level controls. If not, the auditor should perform tests of controls at some of the locations or business units.

B3. No further work is necessary on the remaining locations or businesses, provided that they are not able to create, either individually or in the aggregate, a material misstatement in the financial statements.

Locations or Business Units That Are Financially Significant

B4. Because of the importance of financially significant locations or business units, the auditor should evaluate management's documentation of and perform tests of controls over all relevant assertions related to significant accounts and disclosures at each financially significant location or business unit, as discussed in paragraphs 83 through 105. Generally, a relatively small number of locations or business units will encompass a large portion of a company's operations and financial position, making them financially significant.

B5. In determining the nature, timing, and extent of testing at the individual locations or business units, the auditor should evaluate each entity's involvement, if any, with a central processing or shared service environment.

Locations or Business Units That Involve Specific Risks

B6. Although a location or business unit might not be individually financially significant, it might present specific risks that, by themselves, could create a material misstatement in the company's financial statements. The auditor should test the controls over the specific risks that could create a material misstatement in the company's financial statements. The auditor need not test controls over all relevant assertions related to all significant accounts at these locations or business units. For example, a business unit responsible for foreign exchange trading could expose the company to the risk of material misstatement, even though the relative financial significance of such transactions is low.

Locations or Business Units That Are Significant Only When Aggregated with Other Locations and Business Units

B7. In determining the nature, timing, and extent of testing, the auditor should determine whether management has documented and placed in operation company-level controls (See paragraph 53) over individually unimportant locations and business units that, when aggregated with other locations or business units, might have a high level of financial significance. A high level of financial significance could create a greater than remote risk of material misstatement of the financial statements.

B8. For the purposes of this evaluation, company-level controls are controls management has in place to provide assurance that appropriate controls exist throughout the organization, including at individual locations or business units.

B9. The auditor should perform tests of company-level controls to determine whether such controls are operating effectively. The auditor might conclude that he or she cannot evaluate the operating effectiveness of such controls without visiting some or all of the locations or business units.

B10. If management does not have company-level controls operating at these locations and business units, the auditor should determine the nature, timing, and extent of procedures to be performed at each location, business unit, or combination of locations and business units. When determining the locations or business units to visit and the controls to test, the auditor should evaluate the following factors:

- The relative financial significance of each location or business unit.

- The risk of material misstatement arising from each location or business unit.

- The similarity of business operations and internal control over financial reporting at the various locations or business units.

- The degree of centralization of processes and financial reporting applications.

- The effectiveness of the control environment, particularly management's direct control over the exercise of authority delegated to others and its ability to effectively supervise activities at the various locations or business units. An ineffective control environment over the locations or business units might constitute a material weakness.

- The nature and amount of transactions executed and related assets at the various locations or business units.

- The potential for material unrecognized obligations to exist at a location or business unit and the degree to which the location or business unit could create an obligation on the part of the company.

- Management's risk assessment process and analysis for excluding a location or business unit from its assessment of internal control over financial reporting.

B11. Testing company-level controls is not a substitute for the auditor's testing of controls over a large portion of the company's operations or financial position. If the auditor cannot test a large portion of the company's operations and financial position by selecting a relatively small number of locations or business units, he or she should expand the number of locations or business units selected to evaluate internal control over financial reporting.

> Note: The evaluation of whether controls over a large portion of the company's operations or financial position have been tested should be made at the overall level, not at the individual significant account level.

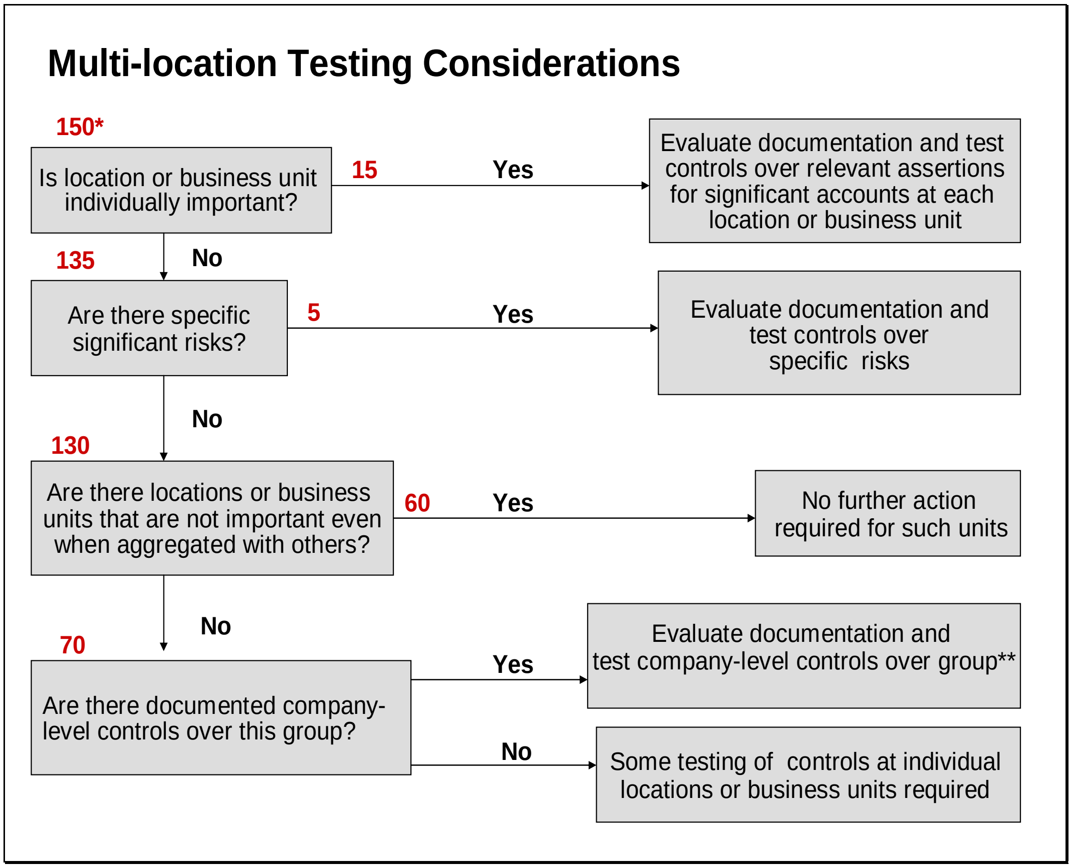
Locations and Business Units That Do Not Require Testing

B12. No testing is required for locations or business units that individually, and when aggregated with others, could not result in a material misstatement to the financial statements.

Multi-Location Testing Considerations Flowchart

B13. Illustration B-1 depicts how to apply the directions in this section to a hypothetical company with 150 locations or business units, along with the auditor's testing considerations for those locations or business units.

Illustration B-1



* Numbers represent number of locations affected.
** See paragraph B7.

Special Situations

B14. The scope of the evaluation of the company's internal control over financial reporting should include entities that are acquired on or before the date of management's assessment and operations that are accounted for as discontinued operations on the date of management's assessment. The auditor should consider this multiple locations discussion in determining whether it will be necessary to test controls at these entities or operations.

B15. For equity method investments, the evaluation of the company's internal control over financial reporting should include controls over the reporting in accordance with generally accepted accounting principles, in the company's financial statements, of the company's portion of the investees' income or loss, the investment balance, adjustments to the income or loss and investment balance, and related disclosures. The evaluation ordinarily would not extend to controls at the equity method investee.

B16. In situations in which the SEC allows management to limit its assessment of internal control over financial reporting by excluding certain entities, the auditor may limit the audit in the same manner and report without reference to the limitation in scope. However, the auditor should evaluate the reasonableness of management's conclusion that the situation meets the criteria of the SEC's allowed exclusion and the appropriateness of any required disclosure related to such a limitation. If the auditor believes that management's disclosure about the limitation requires modification, the auditor should follow the same communication responsibilities as described in paragraphs 204 and 205. If management and the audit committee do not respond appropriately, in addition to fulfilling those responsibilities, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons why the auditor believes management's disclosure should be modified.

B17. For example, for entities that are consolidated or proportionately consolidated, the evaluation of the company's internal control over financial reporting should include controls over significant accounts and processes that exist at the consolidated or proportionately consolidated entity. In some instances, however, such as for some variable interest entities as defined in Financial Accounting Standards Board Interpretation No. 46, *Consolidation of Variable Interest Entities,* management might not be able to obtain the information necessary to make an assessment because it does not have the ability to control the entity. If management is allowed to limit its assessment by excluding such entities,[38/] the auditor may limit the audit in the same manner and report without reference to the limitation in scope. In this case, the evaluation of the company's internal control over financial reporting should include evaluation of controls over the reporting in accordance with generally accepted accounting principles, in the company's financial statements, of the company's portion of the entity's income or loss, the investment balance, adjustments to the income or loss and investment balances, and related disclosures. However, the auditor should evaluate the reasonableness of management's conclusion that it does not have the ability to obtain the necessary information as well as the appropriateness of any required disclosure related to such a limitation.

[38/] It is our understanding that the SEC Staff may conclude that management can limit the scope of its assessment if it does not have the authority to affect, and therefore cannot assess, the controls in place over certain amounts. This would relate to entities that are consolidated or proportionately consolidated when the issuer does not have sufficient control over the entity to assess and affect controls. If management's report on its assessment of the effectiveness of internal control over financial reporting is limited in that manner, the SEC staff may permit the company to disclose this fact as well as information about the magnitude of the amounts included in the financial statements from entities whose controls cannot be assessed. This disclosure would be required in each filing, but outside of management's report on its assessment of the effectiveness of internal control over financial reporting.

Use of Service Organizations

B18. AU sec. 324, *Service Organizations,* applies to the audit of financial statements of a company that obtains services from another organization that are part of its information system. The auditor may apply the relevant concepts described in AU sec. 324 to the audit of internal control over financial reporting. Further, although AU sec. 324 was designed to address auditor-to-auditor communications as part of the audit of financial statements, it also is appropriate for management to apply the relevant concepts described in that standard to its assessment of internal control over financial reporting.

B19. Paragraph .03 of AU sec. 324 describes the situation in which a service organization's services are part of a company's information system. If the service organization's services are part of a company's information system, as described therein, then they are part of the information and communication component of the company's internal control over financial reporting. When the service organization's services are part of the company's internal control over financial reporting, management should consider the activities of the service organization in making its assessment of internal control over financial reporting, and the auditor should consider the activities of the service organization in determining the evidence required to support his or her opinion.

> Note: The use of a service organization does not reduce management's responsibility to maintain effective internal control over financial reporting.

B20. Paragraphs .07 through .16 in AU sec. 324 describe the procedures that management and the auditor should perform with respect to the activities performed by the service organization. The procedures include:

a. Obtaining an understanding of the controls at the service organization that are relevant to the entity's internal control and the controls at the user organization over the activities of the service organization, and

b. Obtaining evidence that the controls that are relevant to management's assessment and the auditor's opinion are operating effectively.

B21. Evidence that the controls that are relevant to management's assessment and the auditor's opinion are operating effectively may be obtained by following the procedures described in paragraph .12 of AU sec. 324. These procedures include:

a. Performing tests of the user organization's controls over the activities of the service organization (for example, testing the user organization's independent reperformance of selected items processed by the service organization or testing the user organization's reconciliation of output reports with source documents).

b. Performing tests of controls at the service organization.

c. Obtaining a service auditor's report on controls placed in operation and tests of operating effectiveness, or a report on the application of agreed-upon procedures that describes relevant tests of controls.

   Note: The service auditor's report referred to above means a report with the service auditor's opinion on the service organization's description of the design of its controls, the tests of controls, and results of those tests performed by the service auditor, and the service auditor's opinion on whether the controls tested were operating effectively during the specified period (in other words, "reports on controls placed in operation and tests of operating effectiveness" described in paragraph .24b of AU sec. 324). A service auditor's report that does not include tests of controls, results of the tests, and the service auditor's opinion on operating effectiveness (in other words, "reports on controls placed in operation" described in paragraph .24a of AU sec. 324) does not provide evidence of operating effectiveness. Furthermore, if the evidence regarding operating effectiveness of controls comes from an agreed-upon procedures report rather than a service auditor's report issued pursuant to AU sec. 324, management and the auditor should evaluate whether the agreed-upon procedures report provides sufficient evidence in the same manner described in the following paragraph.

B22. If a service auditor's report on controls placed in operation and tests of operating effectiveness is available, management and the auditor may evaluate whether this report provides sufficient evidence to support the assessment and opinion, respectively. In evaluating whether such a service auditor's report provides sufficient evidence, management and the auditor should consider the following factors:

- The time period covered by the tests of controls and its relation to the date of management's assessment,

- The scope of the examination and applications covered, the controls tested, and the way in which tested controls relate to the company's controls,

- The results of those tests of controls and the service auditor's opinion on the operating effectiveness of the controls.

Note: These factors are similar to factors the auditor would consider in determining whether the report provides sufficient evidence to support the auditor's assessed level of control risk in an audit of the financial statements as described in paragraph .16 of AU sec. 324.

B23. If the service auditor's report on controls placed in operation and tests of operating effectiveness contains a qualification that the stated control objectives might be achieved only if the company applies controls contemplated in the design of the system by the service organization, the auditor should evaluate whether the company is applying the necessary procedures. For example, completeness of processing payroll transactions might depend on the company's validation that all payroll records sent to the service organization were processed by checking a control total.

B24. In determining whether the service auditor's report provides sufficient evidence to support management's assessment and the auditor's opinion, management and the auditor should make inquiries concerning the service auditor's reputation, competence, and independence. Appropriate sources of information concerning the professional reputation of the service auditor are discussed in paragraph .10a of AU sec. 543, *Part of Audit Performed by Other Independent Auditors.*

B25. When a significant period of time has elapsed between the time period covered by the tests of controls in the service auditor's report and the date of management's assessment, additional procedures should be performed. The auditor should inquire of management to determine whether management has identified any changes in the service organization's controls subsequent to the period covered by the service auditor's report (such as changes communicated to management from the service organization, changes in personnel at the service organization with whom management interacts, changes in reports or other data received from the service organization, changes in contracts or service level agreements with the service organization, or errors identified in the service organization's processing). If management has identified such changes, the auditor should determine whether management has performed procedures to evaluate the effect of such changes on the effectiveness of the company's internal control over financial reporting. The auditor also should consider whether the results of other procedures he or she performed indicate that there have been changes in the controls at the service organization that management has not identified.

B26. The auditor should determine whether to obtain additional evidence about the operating effectiveness of controls at the service organization based on the procedures performed by management or the auditor and the results of those procedures and on an evaluation of the following factors. As these factors increase in significance, the need for the auditor to obtain additional evidence increases.

- The elapsed time between the time period covered by the tests of controls in the service auditor's report and the date of management's assessment,

- The significance of the activities of the service organization,

- Whether there are errors that have been identified in the service organization's processing, and

- The nature and significance of any changes in the service organization's controls identified by management or the auditor.

B27. If the auditor concludes that additional evidence about the operating effectiveness of controls at the service organization is required, the auditor's additional procedures may include:

- Evaluating the procedures performed by management and the results of those procedures.

- Contacting the service organization, through the user organization, to obtain specific information.

- Requesting that a service auditor be engaged to perform procedures that will supply the necessary information.

- Visiting the service organization and performing such procedures.

B28. Based on the evidence obtained, management and the auditor should determine whether they have obtained sufficient evidence to obtain the reasonable assurance necessary for their assessment and opinion, respectively.

B29. The auditor should not refer to the service auditor's report when expressing an opinion on internal control over financial reporting.

Examples of Extent-of-Testing Decisions

B30. As discussed throughout this standard, determining the effectiveness of a company's internal control over financial reporting includes evaluating the design and operating effectiveness of controls over all relevant assertions related to all significant accounts and disclosures in the financial statements. Paragraphs 88 through 107 provide the auditor with directions about the nature, timing, and extent of testing of the design and operating effectiveness of internal control over financial reporting.

B31. Examples B-1 through B-4 illustrate how to apply this information in various situations. These examples are for illustrative purposes only.

Example B-1 – ***Daily Programmed Application Control and Daily Information Technology-Dependent Manual Control***

The auditor has determined that cash and accounts receivable are significant accounts to the audit of XYZ Company's internal control over financial reporting. Based on discussions with company personnel and review of company documentation, the auditor learned that the company had the following procedures in place to account for cash received in the lockbox:

a. The company receives a download of cash receipts from the banks.

b. The information technology system applies cash received in the lockbox to individual customer accounts.

c. Any cash received in the lockbox and not applied to a customer's account is listed on an exception report (Unapplied Cash Exception Report).

- Therefore, the application of cash to a customer's account is a programmed application control, while the review and follow-up of unapplied cash from the exception report is a manual control.

To determine whether misstatements in cash (existence assertion) and accounts receivable (existence, valuation, and completeness) would be prevented or detected on a timely basis, the auditor decided to test the controls provided by the system in the daily reconciliation of lock box receipts to customer accounts, as well as the control over reviewing and resolving unapplied cash in the Unapplied Cash Exception Report.

Nature, Timing, and Extent of Procedures. To test the programmed application control, the auditor:

- Identified, through discussion with company personnel, the software used to receive the download from the banks and to process the transactions and determined that the banks supply the download software.

  -- The company uses accounting software acquired from a third-party supplier. The software consists of a number of modules. The client modifies the software only for upgrades supplied by the supplier.

- Determined, through further discussion with company personnel, that the cash module operates the lockbox functionality and the posting of cash to the general ledger. The accounts receivable module posts the cash to individual customer accounts and produces the Unapplied Cash Exception Report, a standard report supplied with the package. The auditor agreed this information to the supplier's documentation.

- Identified, through discussions with company personnel and review of the supplier's documentation, the names, file sizes (in bytes), and locations of the executable files (programs) that operate the functionality under review. The auditor then identified the compilation dates of these programs and agreed them to the original installation date of the application.

- Identified the objectives of the programs to be tested. The auditor wanted to determine whether only appropriate cash items are posted to customers' accounts and matched to customer number, invoice number, amount, etc., and that there is a listing of inappropriate cash items (that is, any of the above items not matching) on the exception report.

In addition, the auditor had evaluated and tested general computer controls, including program changes (for example, confirmation that no unauthorized changes are undertaken) and logical access (for example, data file access to the file downloaded from the banks and user access to the cash and accounts receivable modules) and concluded that they were operating effectively.

To determine whether such programmed controls were operating effectively, the auditor performed a walkthrough in the month of July. The computer controls operate in a systematic manner, therefore, the auditor concluded that it was sufficient to perform a walkthrough for only the one item. During the walkthrough, the auditor performed and documented the following items:

a. Selected one customer and agreed the amount billed to the customer to the cash received in the lockbox.

b. Agreed the total of the lockbox report to the posting of cash receipts in the general ledger.

c. Agreed the total of the cash receipt download from the bank to the lockbox report and supporting documentation.

d. Selected one customer's remittance and agreed amount posted to the customer's account in the accounts receivable subsidiary ledger.

To test the detective control of review and follow up on the Daily Unapplied Cash Exception Report, the auditor:

a. Made inquiries of company personnel. To understand the procedures in place to ensure that all unapplied items are resolved, the time frame in which such resolution takes place, and whether unapplied items are handled properly within the system, the auditor discussed these matters with the employee responsible for reviewing and resolving the Daily Unapplied Cash Exception Reports. The auditor learned that, when items appear on the Daily-Unapplied Cash Exception Report, the employee must manually enter the correction into the system. The employee typically performs the resolution procedures the next business day. Items that typically appear on the Daily Unapplied Cash Exception Report relate to payments made by a customer without reference to an invoice number/purchase order number or to underpayments of an invoice due to quantity or pricing discrepancies.

b. Observed personnel performing the control**.** The auditor then observed the employee reviewing and resolving a Daily Unapplied Cash Exception Report. The day selected contained four exceptions – three related to payments made by a customer without an invoice number, and one related to an underpayment due to a pricing discrepancy.

- For the pricing discrepancy, the employee determined, through discussions with a sales person, that the customer had been billed an incorrect price; a price break that the sales person had granted to the customer was not reflected on the customer's invoice. The employee resolved the pricing discrepancy, determined which invoices were being paid, and entered a correction into the system to properly apply cash to the customer's account and reduce accounts receivable and sales accounts for the amount of the price break.

c. Reperformed the control. Finally, the auditor selected 25 Daily Unapplied Cash Exception Reports from the period January to September. For the reports selected, the auditor reperformed the follow-up procedures that the employee performed. For instance, the auditor inspected the documents and sources of information used in the follow-up and determined that the transaction was properly corrected in the system. The auditor also scanned other Daily Unapplied Cash Exception Reports to determine that the control was performed throughout the period of intended reliance.

Because the tests of controls were performed at an interim date, the auditor had to determine whether there were any significant changes in the controls from interim to year-end. Therefore, the auditor asked company personnel about the procedures in place at year-end. Such procedures had not changed from the interim period, therefore, the auditor observed that the controls were still in place by scanning Daily Unapplied Cash Exception Reports to determine the control was performed on a timely basis during the period from September to year-end.

Based on the auditor's procedures, the auditor concluded that the employee was clearing exceptions in a timely manner and that the control was operating effectively as of year-end.

Example B-2 – ***Monthly Manual Reconciliation***

The auditor determined that accounts receivable is a significant account to the audit of XYZ Company's internal control over financial reporting. Through discussions with company personnel and review of company documentation, the auditor learned that company personnel reconcile the accounts receivable subsidiary ledger to the general ledger on a monthly basis. To determine whether misstatements in accounts receivable (existence, valuation, and completeness) would be detected on a timely basis, the auditor decided to test the control provided by the monthly reconciliation process.

Nature, Timing, and Extent of Procedures. The auditor tested the company's reconciliation control by selecting a sample of reconciliations based upon the number of accounts, the dollar value of the accounts, and the volume of transactions affecting the account. Because the auditor considered all other receivable accounts immaterial, and because such accounts had only minimal transactions flowing through them, the auditor decided to test only the reconciliation for the trade accounts receivable account. The auditor elected to perform the tests of controls over the reconciliation process in conjunction with the auditor's substantive procedures over the accounts receivable confirmation procedures, which were performed in July.

To test the reconciliation process, the auditor:

a. Made inquiries of personnel performing the control. The auditor asked the employee performing the reconciliation a number of questions, including the following:

   - What documentation describes the account reconciliation process?
   - How long have you been performing the reconciliation work?
   - What is the reconciliation process for resolving reconciling items?
   - How often are the reconciliations formally reviewed and signed off?
   - If significant issues or reconciliation problems are noticed, to whose attention do you bring them?
   - On average, how many reconciling items are there?
   - How are old reconciling items treated?
   - If need be, how is the system corrected for reconciling items?
   - What is the general nature of these reconciling items?

b. Observed the employee performing the control**.** The auditor observed the employee performing the reconciliation procedures. For nonrecurring reconciling items, the auditor observed whether each item included a clear explanation as to its nature, the action that had been taken to resolve it, and whether it had been resolved on a timely basis.

c. Reperformed the control**.** Finally, the auditor inspected the reconciliations and reperfomed the reconciliation procedures. For the May and July reconciliations, the auditor traced the reconciling amounts to the source documents on a test basis. The only reconciling item that appeared on these reconciliations was cash received in the lockbox the previous day that had not been applied yet to the customer's account. The auditor pursued the items in each month's reconciliation to determine that the reconciling item cleared the following business day. The auditor also scanned through the file of all reconciliations prepared during the year and noted that they had been performed on a timely basis. To determine that the company had not made significant changes in its reconciliation control procedures from interim to year-end, the auditor made inquiries of company personnel and determined that such procedures had not changed from interim to year-end. Therefore, the auditor verified that controls were still in place by scanning the monthly account reconciliations to determine that the control was performed on a timely basis during the interim to year-end period.

Based on the auditor's procedures, the auditor concluded that the reconciliation control was operating effectively as of year-end.

Example B-3 – ***Daily Manual Preventive Control***

The auditor determined that cash and accounts payable were significant accounts to the audit of the company's internal control over financial reporting. Through discussions with company personnel, the auditor learned that company personnel make a cash disbursement only after they have matched the vendor invoice to the receiver and purchase order. To determine whether misstatements in cash (existence) and accounts payable (existence, valuation, and completeness) would be prevented on a timely basis, the auditor tested the control over making a cash disbursement only after matching the invoice with the receiver and purchase.

Nature, Timing, and Extent of Procedures. On a haphazard basis, the auditor selected 25 disbursements from the cash disbursement registers from January through September. In this example, the auditor deemed a test of 25 cash disbursement transactions an appropriate sample size because the auditor was testing a manual control performed as part of the routine processing of cash disbursement transactions through the system. Furthermore, the auditor expected no errors based on the results of company-level tests performed earlier. [If, however, the auditor had encountered a control exception, the auditor would have attempted to identify the root cause of the exception and tested an additional number of items. If another control exception had been noted, the auditor would have decided that this control was not effective. As a result, the auditor would have decided to increase the extent of substantive procedures to be performed in connection with the financial statement audit of the cash and accounts payable accounts.]

a. After obtaining the related voucher package, the auditor examined the invoice to see if it included the signature or initials of the accounts payable clerk, evidencing the clerk's performance of the matching control. However, a signature on a voucher package to indicate signor approval does not necessarily mean that the person carefully reviewed it before signing. The voucher package may have been signed based on only a cursory review, or without any review.

b. The auditor decided that the quality of the evidence regarding the effective operation of the control evidenced by a signature or initials was not sufficiently persuasive to ensure that the control operated effectively during the test period. In order to obtain additional evidence, the auditor reperformed the matching control corresponding to the signature, which included examining the invoice to determine that (a) its items matched to the receiver and purchase order and (b) it was mathematically accurate.

Because the auditor performed the tests of controls at an interim date, the auditor updated the testing through the end of the year (initial tests are through September to December) by asking the accounts payable clerk whether the control was still in place and operating effectively. The auditor confirmed that understanding by performing a walkthrough of one transaction in December.

Based on the auditor's procedures, the auditor concluded that the control over making a cash disbursement only after matching the invoice with the receiver and purchase was operating effectively as of year-end.

Example B-4 – ***Programmed Prevent Control and Weekly Information Technology-Dependent Manual Detective Control***

The auditor determined that cash, accounts payable, and inventory were significant accounts to the audit of the company's internal control over financial reporting. Through discussions with company personnel, the auditor learned that the company's computer system performs a three-way match of the receiver, purchase order, and invoice. If there are any exceptions, the system produces a list of unmatched items that employees review and follow up on weekly.

In this case, the computer match is a programmed application control, and the review and follow-up of the unmatched items report is a detective control. To determine whether misstatements in cash (existence) and accounts payable/inventory (existence, valuation, and completeness) would be prevented or detected on a timely basis, the auditor decided to test the programmed application control of matching the receiver, purchase order, and invoice as well as the review and follow-up control over unmatched items.

Nature, Timing, and Extent of Procedures. To test the programmed application control, the auditor:

a. Identified, through discussion with company personnel, the software used to process receipts and purchase invoices. The software used was a third-party package consisting of a number of modules.

b. Determined, through further discussion with company personnel, that they do not modify the core functionality of the software, but sometimes make personalized changes to reports to meet the changing needs of the business. From previous experience with the company's information technology environment, the auditor believes that such changes are infrequent and that information technology process controls are well established.

c. Established, through further discussion, that the inventory module operated the receiving functionality, including the matching of receipts to open purchase orders. Purchase invoices were processed in the accounts payable module, which matched them to an approved purchase order against which a valid receipt has been made. That module also produced the Unmatched Items Report, a standard report supplied with the package to which the company has not made any modifications. That information was agreed to the supplier's documentation and to documentation within the information technology department.

d. Identified, through discussions with the client and review of the supplier's documentation, the names, file sizes (in bytes), and locations of the executable files (programs) that operate the functionality under review. The auditor then identified the compilation dates of the programs and agreed them to the original installation date of the application. The compilation date of the report code was agreed to documentation held within the information technology department relating to the last change made to that report (a change in formatting).

e. Identified the objectives of the programs to be tested. The auditor wanted to determine whether appropriate items are received (for example, match a valid purchase order), appropriate purchase invoices are posted (for example, match a valid receipt and purchase order, non-duplicate reference numbers) and unmatched items (for example, receipts, orders or invoices) are listed on the exception report. The auditor then reperformed all those variations in the packages on a test-of-one basis to determine that the programs operated as described.

In addition, the auditor had evaluated and tested general computer controls, including program changes (for example, confirmation that no unauthorized changes are undertaken to the functionality and that changes to reports are appropriately authorized, tested, and approved before being applied) and logical access (for example, user access to the inventory and accounts payable modules and access to the area on the system where report code is maintained), and concluded that they were operating effectively. (Since the computer is deemed to operate in a systematic manner, the auditor concluded that it was sufficient to perform a walkthrough for only the one item.)

To determine whether the programmed control was operating effectively, the auditor performed a walkthrough in the month of July. As a result of the walkthrough, the auditor performed and documented the following items:

a. Receiving cannot record the receipt of goods without matching the receipt to a purchase order on the system. The auditor tested that control by attempting to record the receipt of goods into the system without a purchase order. However, the system did not allow the auditor to do that. Rather, the system produced an error message stating that the goods could not be recorded as received without an active purchase order.

b. An invoice will not be paid unless the system can match the receipt and vendor invoice to an approved purchase order. The auditor tested that control by attempting to approve an invoice for payment in the system. The system did not allow the auditor to do that. Rather, it produced an error message indicating that invoices could not be paid without an active purchase order and receiver.

c. The system disallows the processing of invoices with identical vendor and identical invoice numbers. In addition, the system will not allow two invoices to be processed against the same purchase order unless the sum of the invoices is less than the amount approved on the purchase order. The auditor tested that control by attempting to process duplicate invoices. However, the system produced an error message indicating that the invoice had already been processed.

d. The system compares the invoice amounts to the purchase order. If there are differences in quantity/extended price, and such differences fall outside a pre-approved tolerance, the system does not allow the invoice to be processed. The auditor tested that control by attempting to process an invoice that had quantity/price differences outside the tolerance level of 10 pieces, or $1,000. The system produced an error message indicating that the invoice could not be processed because of such differences.

e. The system processes payments only for vendors established in the vendor master file. The auditor tested that control by attempting to process an invoice for a vendor that was not established in the vendor master file. However, the system did not allow the payment to be processed.

f. The auditor tested user access to the vendor file and whether such users can make modifications to such file by attempting to access and make changes to the vendor tables. However, the system did not allow the auditor to perform that function and produced an error message stating that the user was not authorized to perform that function.

g. The auditor verified the completeness and accuracy of the Unmatched Items Report by verifying that one unmatched item was on the report and one matched item was not on the report.

Note: It is inadvisable for the auditor to have uncontrolled access to the company's systems in his or her attempts described above to record the receipt of goods without a purchase order, approve an invoice for payment, process duplicate invoices, etc. These procedures ordinarily are performed in the presence of appropriate company personnel so that they can be notified immediately of any breach to their systems.

To test the detect control of review and follow up on the Unmatched Items Report, the auditor performed the following procedures in the month of July for the period January to July:

a. Made inquiries of company personnel. To gain an understanding of the procedures in place to ensure that all unmatched items are followed-up properly and that corrections are made on a timely basis, the auditor made inquiries of the employee who follows up on the weekly-unmatched items reports. On a weekly basis, the control required the employee to review the Unmatched Items Report to determine why items appear on it. The employee's review includes proper follow-up on items, including determining whether:

   - All open purchase orders are either closed or voided within an acceptable amount of time.
   - The requesting party is notified periodically of the status of the purchase order and the reason for its current status.
   - The reason the purchase order remains open is due to incomplete shipment of goods and, if so, whether the vendor has been notified.
   - There are quantity problems that should be discussed with purchasing.

b. Observed the performance of the control**.** The auditor observed the employee performing the control for the Unmatched Items Reports generated during the first week in July.

c. Reperformed the control**.** The auditor selected five weekly Unmatched Items Reports, selected several items from each, and reperformed the procedures that the employee performed. The auditor also scanned other Unmatched Items Reports to determine that the control was performed throughout the period of intended reliance.

To determine that the company had not made significant changes in their controls from interim to year-end, the auditor discussed with company personnel the procedures in place for making such changes. Since the procedures had not changed from interim to year-end, the auditor observed that the controls were still in place by scanning the weekly Unmatched Items Reports to determine that the control was performed on a timely basis during the interim to year-end period.

Based on the auditor's procedures, the auditor concluded that the employee was clearing exceptions in a timely manner and that the control was operating effectively as of year-end.

APPENDIX C

Safeguarding of Assets

C1. *Safeguarding of assets* is defined in paragraph 7 as those policies and procedures that "provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements." This definition is consistent with the definition provided in the Committee of Sponsoring Organizations (COSO) of the Treadway Commission's Addendum, *Reporting to External Parties*, which provides the following definition of internal control over safeguarding of assets:

> Internal control over safeguarding of assets against unauthorized acquisition, use or disposition is a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements. Such internal control can be judged effective if the board of directors and management have reasonable assurance that unauthorized acquisition, use or disposition of the entity's assets that could have a material effect on the financial statements is being prevented or detected on a timely basis.

C2. For example, a company has safeguarding controls over inventory tags (preventive controls) and also performs periodic physical inventory counts (detective control) timely in relation to its quarterly and annual financial reporting dates. Although the physical inventory count does not safeguard the inventory from theft or loss, it prevents a material misstatement to the financial statements if performed effectively and timely.

C3. Therefore, given that the definitions of material weakness and significant deficiency relate to the likelihood of misstatement of the financial statements, the failure of a preventive control such as inventory tags will not result in a significant deficiency or material weakness if the detective control (physical inventory) prevents a misstatement of the financial statements. The COSO Addendum also indicates that to the extent that such losses might occur, controls over financial reporting are effective if they provide reasonable assurance that those losses are properly reflected in the financial statements, thereby alerting financial statement users to consider the need for action.

Note: *Properly reflected* in the financial statements includes both correctly recording the loss and adequately disclosing the loss.

C4. Material weaknesses relating to controls over the safeguarding of assets would only exist when the company does not have effective controls (considering both safeguarding and other controls) to prevent or detect a material misstatement of the financial statements.

C5. Furthermore, management's plans that could potentially affect financial reporting in future periods are not controls. For example, a company's business continuity or contingency planning has no effect on the company's current abilities to initiate, authorize, record, process, or report financial data. Therefore, a company's business continuity or contingency planning is not part of internal control over financial reporting.

C6. The COSO Addendum provides further information about safeguarding of assets as it relates to internal control over financial reporting.

APPENDIX D

Examples of Significant Deficiencies and Material Weaknesses

D1. Paragraph 8 of this standard defines a control deficiency. Paragraphs 9 and 10 go on to define a significant deficiency and a material weakness, respectively.

D2. Paragraphs 22 through 23 of this standard discuss materiality in an audit of internal control over financial reporting, and paragraphs 130 through 140 provide additional direction on evaluating deficiencies in internal control over financial reporting.

D3. The following examples illustrate how to evaluate the significance of internal control deficiencies in various situations. These examples are for illustrative purposes only.

Example D-1**— *Reconciliations of Intercompany Accounts Are Not Performed on a Timely Basis***

Scenario A – Significant Deficiency. The company processes a significant number of routine intercompany transactions on a monthly basis. Individual intercompany transactions are not material and primarily relate to balance sheet activity, for example, cash transfers between business units to finance normal operations.

A formal management policy requires monthly reconciliation of intercompany accounts and confirmation of balances between business units. However, there is not a process in place to ensure performance of these procedures. As a result, detailed reconciliations of intercompany accounts are not performed on a timely basis. Management does perform monthly procedures to investigate selected large-dollar intercompany account differences. In addition, management prepares a detailed monthly variance analysis of operating expenses to assess their reasonableness.

Based only on these facts, the auditor should determine that this deficiency represents a significant deficiency for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be more than inconsequential, but less than material, because individual intercompany transactions are not material, and the compensating controls operating monthly should detect a material misstatement. Furthermore, the transactions are primarily restricted to balance sheet accounts. However, the compensating detective controls are designed only to detect material misstatements. The controls do not address the detection of misstatements that are more than inconsequential but less than material. Therefore, the likelihood that a misstatement that was more than inconsequential, but less than material, could occur is more than remote.

Scenario B - Material Weakness. The company processes a significant number of intercompany transactions on a monthly basis. Intercompany transactions relate to a wide range of activities, including transfers of inventory with intercompany profit between business units, allocation of research and development costs to business units and corporate charges. Individual intercompany transactions are frequently material.

A formal management policy requires monthly reconciliation of intercompany accounts and confirmation of balances between business units. However, there is not a process in place to ensure that these procedures are performed on a consistent basis. As a result, reconciliations of intercompany accounts are not performed on a timely basis, and differences in intercompany accounts are frequent and significant. Management does not perform any alternative controls to investigate significant intercompany account differences.

Based only on these facts, the auditor should determine that this deficiency represents a material weakness for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be material, because individual intercompany transactions are frequently material and relate to a wide range of activities. Additionally, actual unreconciled differences in intercompany accounts have been, and are, material. The likelihood of such a misstatement is more than remote because such misstatements have frequently occurred and compensating controls are not effective, either because they are not properly designed or not operating effectively. Taken together, the magnitude and likelihood of misstatement of the financial statements resulting from this internal control deficiency meet the definition of a material weakness.

Example D-2—***Modifications to Standard Sales Contract Terms Not Reviewed To Evaluate Impact on Timing and Amount of Revenue Recognition***

Scenario A – Significant Deficiency. The company uses a standard sales contract for most transactions. Individual sales transactions are not material to the entity. Sales personnel are allowed to modify sales contract terms. The company's accounting function reviews significant or unusual modifications to the sales contract terms, but does not review changes in the standard shipping terms. The changes in the standard shipping terms could require a delay in the timing of revenue recognition. Management reviews gross margins on a monthly basis and investigates any significant or unusual relationships. In addition, management reviews the reasonableness of inventory levels at the end of each accounting period. The entity has experienced limited situations in which revenue has been inappropriately recorded in advance of shipment, but amounts have not been material.

Based only on these facts, the auditor should determine that this deficiency represents a significant deficiency for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be more than inconsequential, but less than material, because individual sales transactions are not material and the compensating detective controls operating monthly and at the end of each financial reporting period should reduce the likelihood of a material misstatement going undetected. Furthermore, the risk of material misstatement is limited to revenue recognition errors related to shipping terms as opposed to broader sources of error in revenue recognition. However, the compensating detective controls are only designed to detect material misstatements. The controls do not effectively address the detection of misstatements that are more than inconsequential but less than material, as evidenced by situations in which transactions that were not material were improperly recorded. Therefore, there is a more than remote likelihood that a misstatement that is more than inconsequential but less than material could occur.

Scenario B - Material Weakness. The company has a standard sales contract, but sales personnel frequently modify the terms of the contract. The nature of the modifications can affect the timing and amount of revenue recognized. Individual sales transactions are frequently material to the entity, and the gross margin can vary significantly for each transaction.

The company does not have procedures in place for the accounting function to regularly review modifications to sales contract terms. Although management reviews gross margins on a monthly basis, the significant differences in gross margins on individual transactions make it difficult for management to identify potential misstatements. Improper revenue recognition has occurred, and the amounts have been material.

Based only on these facts, the auditor should determine that this deficiency represents a material weakness for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be material, because individual sales transactions are frequently material, and gross margin can vary significantly with each transaction (which would make compensating detective controls based on a reasonableness review ineffective). Additionally, improper revenue recognition has occurred, and the amounts have been material. Therefore, the likelihood of material misstatements occurring is more than remote. Taken together, the magnitude and likelihood of misstatement of the financial statements resulting from this internal control deficiency meet the definition of a material weakness.

Scenario C – Material Weakness. The company has a standard sales contract, but sales personnel frequently modify the terms of the contract. Sales personnel frequently grant unauthorized and unrecorded sales discounts to customers without the knowledge of the accounting department. These amounts are deducted by customers in paying their invoices and are recorded as outstanding balances on the accounts receivable aging. Although these amounts are individually insignificant, they are material in the aggregate and have occurred consistently over the past few years.

Based on only these facts, the auditor should determine that this deficiency represents a material weakness for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be material, because the frequency of occurrence allows insignificant amounts to become material in the aggregate. The likelihood of material misstatement of the financial statements resulting from this internal control deficiency is more than remote (even assuming that the amounts were fully reserved for in the company's allowance for uncollectible accounts) due to the likelihood of material misstatement of the gross accounts receivable balance. Therefore, this internal control deficiency meets the definition of a material weakness.

Example D-3—***Identification of Several Deficiencies***

Scenario A – Material Weakness. During its assessment of internal control over financial reporting, management identified the following deficiencies. Based on the context in which the deficiencies occur, management and the auditor agree that these deficiencies individually represent significant deficiencies:

- Inadequate segregation of duties over certain information system access controls.

- Several instances of transactions that were not properly recorded in subsidiary ledgers; transactions were not material, either individually or in the aggregate.

- A lack of timely reconciliations of the account balances affected by the improperly recorded transactions.

Based only on these facts, the auditor should determine that the combination of these significant deficiencies represents a material weakness for the following reasons: Individually, these deficiencies were evaluated as representing a more than remote likelihood that a misstatement that is more than inconsequential, but less than material, could occur. However, each of these significant deficiencies affects the same set of accounts. Taken together, these significant deficiencies represent a more than remote likelihood that a material misstatement could occur and not be prevented or detected. Therefore, in combination, these significant deficiencies represent a material weakness.

Scenario B – Material Weakness. During its assessment of internal control over financial reporting, management of a financial institution identifies deficiencies in: the design of controls over the estimation of credit losses (a critical accounting estimate); the operating effectiveness of controls for initiating, processing, and reviewing adjustments to the allowance for credit losses; and the operating effectiveness of controls designed to prevent and detect the improper recognition of interest income. Management and the auditor agree that, in their overall context, each of these deficiencies individually represent a significant deficiency.

In addition, during the past year, the company experienced a significant level of growth in the loan balances that were subjected to the controls governing credit loss estimation and revenue recognition, and further growth is expected in the upcoming year.

Based only on these facts, the auditor should determine that the combination of these significant deficiencies represents a material weakness for the following reasons:

- The balances of the loan accounts affected by these significant deficiencies have increased over the past year and are expected to increase in the future.

- This growth in loan balances, coupled with the combined effect of the significant deficiencies described, results in a more than remote likelihood that a material misstatement of the allowance for credit losses or interest income could occur.

Therefore, in combination, these deficiencies meet the definition of a material weakness.

APPENDIX E

BACKGROUND AND BASIS FOR CONCLUSIONS

Table of Contents — ***Paragraph***

Introduction

E1. This appendix summarizes factors that the Public Company Accounting Oversight Board (the "Board") deemed significant in reaching the conclusions in the standard. This appendix includes reasons for accepting certain views and rejecting others.

Background

E2. Section 404(a) of the Sarbanes-Oxley Act of 2002 (the "Act"), and the Securities and Exchange Commission's (SEC) related implementing rules, require the management of a public company to assess the effectiveness of the company's internal control over financial reporting, as of the end of the company's most recent fiscal year. Section 404(a) of the Act also requires management to include in the company's annual report to shareholders management's conclusion as a result of that assessment of whether the company's internal control over financial reporting is effective.

E3. 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.

E4. The backdrop for the development of the Board's first major auditing standard was, of course, the spectacular audit failures and corporate malfeasance that led to the passage of the Act. Although all of the various components of the Act work together to help restore investor confidence and help prevent the types of financial reporting breakdowns that lead to the loss of investor confidence, Section 404 of the Act is certainly one of the most visible and tangible changes required by the Act.

E5. The Board believes that effective controls provide the foundation for reliable financial reporting. Congress believed this too, which is why the new reporting by management and the auditor on the effectiveness of internal control over financial reporting received such prominent attention in the Act. Internal control over financial reporting enhances a company's ability to produce fair and complete financial reports. Without reliable financial reports, making good judgments and decisions about a company becomes very difficult for anyone, including the board of directors, management, employees, investors, lenders, customers, and regulators. The auditor's reporting on management's assessment of the effectiveness of internal control over financial reporting provides users of that report with important assurance about the reliability of the company's financial reporting.

E6. The Board's efforts to develop this standard were an outward expression of the Board's mission, "to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports." As part of fulfilling that mission as it relates to this standard, the Board considered the advice that respected groups had offered to other auditing standards setters in the past. For example, the Public Oversight Board's Panel on Audit Effectiveness recommended that "auditing standards need to provide clear, concise and definitive imperatives for auditors to follow."[39/] As another example, the International Organization of Securities Commissioners advised the International Auditing and Assurance Standards Board "that the IAASB must take care to avoid language that could inadvertently encourage inappropriate shortcuts in audits, at a time when rigorous audits are needed more than ever to restore investor confidence."[40/]

E7. The Board understood that, to effectively fulfill its mission and for this standard to achieve its ultimate goal of restoring investor confidence by increasing the reliability of public company financial reporting, the Board's standard must contain clear directions to the auditor consistent with investor's expectations that the reliability of financial reporting be significantly improved. Just as important, the Board recognized that this standard must appropriately balance the costs to implement the standard's directions with the benefits of achieving these important goals. As a result, all of the Board's decisions about this standard were guided by the additional objective of creating a rational relationship between costs and benefits.

E8. When the Board adopted its interim attestation standards in Rule 3300T on an initial, transitional basis, the Board adopted a pre-existing standard governing an auditor's attestation on internal control over financial reporting.[41/] As part of the Board's process of evaluating that pre-existing standard, the Board convened a public roundtable discussion on July 29, 2003 to discuss issues and hear views related to reporting on internal control over financial reporting. The

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39/ Panel on Audit Effectiveness, *Report and Recommendations,* sec. 2.228 (August 31, 2000).

40/ April 8, 2003 comment letter from the International Organization of Securities Commissions to the International Auditing and Assurance Standards Board regarding the proposed international standards on audit risk (Amendment to ISA 200, "Objective and Principles Governing an Audit of Financial Statements;" proposed ISAs, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement;" "Auditor's Procedures in Response to Assessed Risks;" and "Audit Evidence").

41/ The pre-existing standard is Chapter 5, "*Reporting on an Entity's Internal Control Over Financial Reporting*" of Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards,* Vol. 1, AT sec. 501). SSAE No. 10 has been codified into AICPA *Professional Standards,* Volume 1, as AT sections 101 through 701.

participants at the roundtable included representatives from public companies, accounting firms, investor groups, and regulatory organizations. Based on comments made at the roundtable, advice from the Board's staff, and other input the Board received, the Board determined that the pre-existing standard governing an auditor's attestation on internal control over financial reporting was insufficient for effectively implementing the requirements of Section 404 of the Act and for the Board to appropriately discharge its standard-setting obligations under Section 103(a) of the Act. In response, the Board developed and issued, on October 7, 2003, a proposed auditing standard titled, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements.*

E9. The Board received 189 comment letters on a broad array of topics from a variety of commenters, including auditors, investors, internal auditors, issuers, regulators, and others. Those comments led to changes in the standard, intended to make the requirements of the standard clearer and more operational. This appendix summarizes significant views expressed in those comment letters and the Board's responses.

Fundamental Scope of the Auditor's Work in an Audit of Internal Control over Financial Reporting

E10. The proposed standard stated that the auditor's objective in an audit of internal control over financial reporting was to express an opinion on management's assessment of the effectiveness of the company's internal control over financial reporting. To render such an opinion, the proposed standard required the auditor to obtain reasonable assurance about whether the company maintained, in all material respects, effective internal control over financial reporting as of the date specified in management's report. To obtain reasonable assurance, the auditor was required to evaluate both management's process for making its assessment and the effectiveness of internal control over financial reporting.

E11. Virtually all investors and auditors who submitted comment letters expressed support for this approach. Other commenters, primarily issuers, expressed concerns that this approach was contrary to the intent of Congress and, therefore, beyond what was specifically required by Section 404 of the Act. Further, issuers stated their views that this approach would lead to unnecessary and excessive costs. Some commenters in this group suggested the auditor's work should be limited to evaluating management's assessment process and the testing performed by management and internal audit. Others acknowledged that the auditor would need to test at least some controls directly in addition to evaluating and testing management's assessment process. However, these commenters described various ways in which the auditor's own testing could be significantly reduced from the scope expressed in the proposed standard. For instance, they proposed that the auditor could be permitted to use the work of management and others to a much greater degree; that the auditor could use a "risk analysis" to identify only a few controls to be tested; and a variety of other methods to curtail the extent of the auditor's work. Of those opposed to the scope, most cited their belief that the scope of work embodied in the standard would lead to a duplication of effort between management and the auditor which would needlessly increase costs without adding significant value.

E12. After considering the comments, the Board retained the approach described in the proposed standard. The Board concluded that the approach taken in the standard is consistent with the intent of Congress. Also, to provide the type of report, at the level of assurance called for in Sections 103 and 404, the Board concluded that the auditor must evaluate both management's assessment process and the effectiveness of internal control over financial reporting. Finally, the Board noted the majority of the cost to be borne by companies (and ultimately investors) results directly from the work the company will have to perform to maintain effective internal control over financial reporting and to comply with Section 404(a) of the Act. The cost of the auditor's work as described in this standard ultimately will represent a smaller portion of the total cost to companies of implementing Section 404.

E13. The Board noted that large, federally insured financial institutions have had a similar internal control reporting requirement for over ten years. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) has required, since 1993, managements of large financial institutions to make an assessment of internal control over financial reporting effectiveness and the institution's independent auditor to issue an attestation report on management's assessment.

E14. The attestation standards under which FDICIA engagements are currently performed are clear that, when performing an examination of management's assertion on the effectiveness of internal control over financial reporting (management's report on the assessment required by Section 404(a) of the Act must include a statement as to whether the company's internal control over financial reporting is effective), the auditor may express an opinion either on management's assertion (that is, whether management's assessment about the effectiveness of the internal control over financial reporting is fairly stated) or directly on the subject matter (that is, whether the internal control over financial reporting is effective) because the level of work that must be performed is the same in either case.

E15. The Board observed that Congress indicated an intent to require an examination level of work in Section 103(a) of the Act, which states, in part, that each registered public accounting firm shall:

> describe in each audit report the scope of the auditor's testing of the internal control structure and procedures of the issuer, required by Section 404(b), and present (in such report or in a separate report)—

(I) the findings of the auditor from such testing;

(II) an evaluation of whether such internal control structure and procedures—

(aa) include maintenance of records that in reasonable detail accurately reflect the transactions and dispositions of the assets of the issuer;

(bb) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and

(III) a description, at a minimum, of material weaknesses in such internal controls, and of any material noncompliance found on the basis of such testing. [emphasis added].

E16. The Board concluded that the auditor must test internal control over financial reporting directly, in the manner and extent described in the standard, to make the evaluation described in Section 103. The Board also interpreted Section 103 to provide further support that the intent of Congress was to require an opinion on the effectiveness of internal control over financial reporting.

E17. The Board concluded that the auditor must obtain a high level of assurance that the conclusion expressed in management's assessment is correct to provide an opinion on management's assessment. An auditing process restricted to evaluating what management has done would not provide the auditor with a sufficiently high level of assurance that management's conclusion is correct. Instead, it is necessary for the auditor to evaluate management's assessment process to be satisfied that management has an appropriate basis for its statement, or assertion, about the effectiveness of the company's internal control over financial reporting. It also is necessary for the auditor to directly test the effectiveness of internal control over financial reporting to be satisfied that management's conclusion is correct, and that management's assertion is fairly stated.

E18. This testing takes on added importance with the public nature of the internal control reporting. Because of the auditor's association with a statement by management that internal control over financial reporting is effective, it is reasonable for a user of the auditor's report to expect that the auditor tested the effectiveness of internal control over financial reporting. For the auditor to do otherwise would create an expectation gap, in which the assurance that the auditor obtained is less than what users reasonably expect.

E19. Auditors, investors, and the Federal bank regulators reaffirmed in their comment letters on the proposed auditing standard that the fundamental approach taken by the Board was appropriate and necessary. Investors were explicit in their expectation that the auditor must test the effectiveness of controls directly in addition to evaluating management's assessment process. Investors further recognized that this kind of assurance would come at a price and expressed their belief that the cost of the anticipated benefits was reasonable. The federal banking regulators, based on their experience examining financial institutions' internal control assessments and independent auditors' attestation reports under FDICIA, commented that the proposed auditing standard was a significant improvement over the existing attestation standard.

Reference to Audit vs. Attestation

E20. The proposed standard referred to the attestation required by Section 404(b) of the Act as the *audit* of internal control over financial reporting instead of an *attestation* of management's assessment. The proposed standard took that approach both because the auditor's objective is to express an opinion on management's assessment of the effectiveness of internal control over financial reporting, just as the auditor's objective in an audit of the financial statements is to express an opinion on the fair presentation of the financial statements, and because the level of assurance obtained by the auditor is the same in both cases. Furthermore, the proposed standard described an *integrated* audit of the financial statements and internal control over financial reporting and allowed the auditor to express his or her opinions on the financial statements and on the effectiveness of internal control in separate reports or in a single, combined report.

E21. Commenters' views on this matter frequently were related to their views on whether the proposed scope of the audit was appropriate. Those who agreed that the scope in the proposed standard was appropriate generally agreed that referring to the engagement as an *audit* was appropriate. On the other hand, commenters who objected to the scope of work described in the proposed standard often drew an important distinction between an *audit* and an *attestation.* Because Section 404 calls for an *attestation*, they believed it was inappropriate to call the engagement anything else (or to mandate a scope that called for a more extensive level of work).

E22. Based, in part, on the Board's decisions about the scope of the audit of internal control over financial reporting, the Board concluded that the engagement should continue to be referred to as an "audit." This term emphasizes the nature of the auditor's objective and communicates that objective most clearly to report users. Use of this term also is consistent with the integrated approach described in the standard and the requirement in Section 404 of the Act that this reporting not be subject to a separate engagement.

E23. Because the Board's standard on internal control is an auditing standard, it is preferable to use the term *audit* to describe the engagement rather than the term *examination*, which is used in the attestation standards to describe an engagement designed to provide a high level of assurance.

E24. Finally, the Board believes that using the term *audit* helps dispel the misconception that an audit of internal control over financial reporting is a different level of service than an attestation of management's assessment of internal control over financial reporting.

Form of the Auditor's Opinion

E25. The proposed auditing standard required that the auditor's opinion in his or her report state whether management's assessment of the effectiveness of the company's internal control over financial reporting as of the specified date is fairly stated, in all material respects, based on the control criteria. However, the proposed standard also stated that nothing precluded the auditor from auditing management's assessment and opining directly on the effectiveness of internal control over financial reporting. This is because the scope of the work, as defined by the proposed standard, was the same, regardless of whether the auditor reports on management's assessment or directly on the effectiveness of internal control over financial reporting. The form of the opinion was essentially interchangeable between the two.

E26. However, if the auditor planned to issue other than an unqualified opinion, the proposed standard required the auditor to report directly on the effectiveness of the company's internal control over financial reporting rather than on management's assessment. The Board initially concluded that expressing an opinion on management's assessment, in these circumstances, did not most effectively communicate the auditor's conclusion that internal control was not effective. For example, if management expresses an adverse assessment because a material weakness exists at the date of management's assessment ("…internal control over financial reporting is not effective…") and the auditor expresses his or her opinion on management's assessment ("…management's assessment that internal control over financial reporting is not effective is fairly stated, in all material respects…"), a reader might not be clear about the results of the auditor's testing and about the auditor's conclusions. The Board initially decided that reporting directly on the effectiveness of the company's internal control over financial reporting better communicates to report users the effect of such conditions, because direct reporting more clearly states the auditor's conclusions about the effectiveness of internal control over financial reporting ("In our opinion, because of the effect of the material weakness described…, the Company's internal control over financial reporting is not effective.").

E27. A number of commenters were supportive of the model described in the previous paragraph, as they agreed with the Board's reasoning. However, several commenters believed that report users would be confused as to why the form of the auditor's opinion would be different in various circumstances. These commenters thought that the auditor's opinion should be consistently expressed in all reports. Several auditors recommended that auditors always report directly on the effectiveness of the company's internal control over financial reporting. They reasoned that the scope of the audit—which always would require the auditor to obtain reasonable assurance about whether the internal control over financial reporting was effective—would be more clearly communicated, in all cases, by the auditor reporting directly on the effectiveness of internal control over financial reporting. Other commenters suggested that the auditor always should express two opinions: one on management's assessment and one directly on the effectiveness of internal control over financial reporting. They believed the Act called for two opinions: Section 404 calls for an opinion on management's assessment, while Section 103 calls for an opinion directly on the effectiveness of internal control over financial reporting.

E28. The Board believes that the reporting model in the proposed standard is appropriate. However, the Board concluded that the expression of two opinions—one on management's assessment and one on the effectiveness of internal control over financial reporting—in all reports is a superior approach that balances the concerns of many different interested parties. This approach is consistent with the scope of the audit, results in more consistent reporting in differing circumstances, and makes the reports more easily understood by report users. Therefore, the standard requires that the auditor express two opinions in all reports on internal control over financial reporting.

Use of the Work of Others

E29. After giving serious consideration to a rational relationship between costs and benefits, the Board decided to change the provisions in the proposed standard regarding using the work of others. The proposed standard required the auditor to evaluate whether to use the work of others, such as internal auditors and others working under the direction of management, and described an evaluation process focused on the competence and objectivity of the persons who performed the work that the auditor was required to use when determining the extent to which he or she could use the work of others.

E30. The proposed standard also described two principles that limited the auditor's ability to use of the work of others. First, the proposed standard defined three categories of controls and the extent to which the auditor could use the work of others in each of those categories:

- Controls for which the auditor should not rely on the work of others, such as controls in the control environment and controls specifically intended to prevent or detect fraud that is reasonably likely to have a material effect on the company's financial statements,

- Controls for which the auditor may rely on the work of others, but his or her reliance on the work of others should be limited, such as controls over nonroutine transactions that are considered high risk because they involve judgments and estimates, and

- Controls for which the auditor's reliance on the work of others is not specifically limited, such as controls over routine processing of significant accounts.

E31. Second, the proposed standard required that, on an overall basis, the auditor's own work must provide the principal evidence for the audit opinion (this is referred to as the *principal evidence provision*).

E32. In the proposed standard, these two principles provided the auditor with flexibility in using the work of others while preventing him or her from placing inappropriate over-reliance on the work of others. Although the proposed standard required the auditor to reperform some of the tests performed by others to use their work, it did not establish specific requirements for the extent of the reperformance. Rather, it allowed the auditor to use his or her judgment and the directions provided by the two principles discussed in the previous two paragraphs to determine the appropriate extent of reperformance.

E33. The Board received a number of comments that agreed with the proposed three categories of controls and the principal evidence provision. However, most commenters expressed some level of concern with the categories, the principal evidence provision, or both.

E34. Comments opposing or criticizing the categories of controls varied from general to very specific. In general terms, many commenters (particularly issuers) expressed concern that the categories described in the proposed standard were too restrictive. They believed the auditor should be able to use his or her judgment to determine in which areas and to what extent to rely on the work of others. Other commenters indicated that the proposed standard did not place enough emphasis on the work of internal auditors whose competence and objectivity, as well as adherence to professional standards of internal auditing, should clearly set their work apart from the work performed by others in the organization (such as management or third parties working under management's direction). Further, these commenters believed that the standard should clarify that the auditor should be able to use work performed by internal auditors extensively. In that case, their concerns about excessive cost also would be partially alleviated.

E35. Other commenters expressed their belief that the proposed standard repudiated the approach established in AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,* for the auditor's use of the work of internal auditors in a financial statement audit. Commenters also expressed very specific and pointed views on the three categories of controls. As defined in the proposed standard, the first category (in which the auditor should not use the work of others at all) included:

- Controls that are part of the control environment, including controls specifically established to prevent and detect fraud that is reasonably likely to result in material misstatement of the financial statements.

- Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; to initiate, record, and process journal entries in the general ledger; and to record recurring and nonrecurring adjustments to the financial statements (for example, consolidating adjustments, report combinations, and reclassifications).

- 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.

- Walkthroughs.

E36. Commenters expressed concern that the prohibition on using the work of others in these areas would (a) drive unnecessary and excessive costs, (b) not give appropriate recognition to those instances in which the auditor evaluated internal audit as having a high degree of competence and objectivity, and (c) be impractical due to resource constraints at audit firms. Although each individual area was mentioned, the strongest and most frequent objections were to the restrictions imposed over the inclusion in the first category of walkthroughs, controls over the period-end financial reporting process, and information technology general controls. Some commenters suggested the Board should consider moving these areas from the first category to the second category (in which using the work of others would be limited, rather than prohibited); others suggested removing any limitation on using the work of others in these areas altogether.

E37. Commenters also expressed other concerns with respect to the three control categories. Several commenters asked for clarification on what constituted *limited* use of the work of others for areas included in the second category. Some commenters asked for clarification about the extent of reperformance necessary for the auditor to use the work of others. Other commenters questioned the meaning of the term *without specific limitation* in the third category by asking, did this mean that the auditor could use the work of others in these areas without performing *or* reperforming *any* work in those areas?

E38. Although most commenters suggested that the principal evidence threshold for the auditor's own work be retained, some commenters objected to the principal evidence provision. Although many commenters identified the broad array of areas identified in the first category (in which the auditor should not use the work of others at all) as the key driver of excessive costs, others identified the principal evidence provision as the real source of their excessive cost concerns. Even if the categories were redefined in such a way as to permit the auditor to use the work of others in more areas, any associated decrease in audit cost would be limited by the principal evidence provision which, if retained, would still require significant original work on the part of the auditor. On the other hand, both investors and auditors generally supported retaining the principal evidence provision as playing an important role in ensuring the independence of the auditor's opinion and preventing inappropriate overreliance on the work of internal auditors and others.

E39. Commenters who both supported and opposed the principal evidence provision indicated that implementing it would be problematic because the nature of the work in an audit of internal control over financial reporting does not lend itself to a purely quantitative measurement. Thus, auditors would be forced to use judgment when determining whether the principal evidence provision has been satisfied.

E40. In response to the comments, the Board decided that some changes to the guidance on using the work of others were necessary. The Board did not intend to reject the concepts in AU sec. 322 and replace them with a different model. Although AU sec. 322 is designed to apply to an audit of financial statements, the Board concluded that the concepts contained in AU sec. 322 are sound and should be used in an audit of internal control over financial reporting, with appropriate modification to take into account the differences in the nature of the evidence necessary to support an opinion on financial statements and the evidence necessary to support an opinion on internal control effectiveness. The Board also wanted to make clear that the concepts in AU sec. 322 also may be applied, with appropriate auditor judgment, to the relevant work of others.

E41. The Board remained concerned, however, with the possibility that auditors might overrely on the work of internal auditors and others. Inappropriate overreliance can occur in a variety of ways. For example, an auditor might rely on the work of a highly competent and objective internal audit function for proportionately too much of the evidence that provided the basis for the auditor's opinion. Inappropriate overreliance also occurs when the auditor incorrectly concludes that internal auditors have a high degree of competence and objectivity when they do not, perhaps because the auditor did not exercise professional skepticism or due professional care when making his or her evaluation. In either case, the result is the same: unacceptable risk that the auditor's conclusion that internal control over financial reporting is effective is incorrect. For example, federal bank regulators commented that, in their experience with FDICIA, auditors have a tendency to rely too heavily on the work of management and others, further noting that this situation diminishes the independence of the auditor's opinion on control effectiveness.

E42. The Board decided to revise the categories of controls by focusing on the nature of the controls being tested, evaluating the competence and objectivity of the individuals performing the work, and testing the work of others. This allows the auditor to exercise substantial judgment based on the outcome of this work as to the extent to which he or she can make use of the work of internal auditors or others who are suitably qualified.

E43. This standard emphasizes the direct relationship between the assessed level of competence and objectivity and the extent to which the auditor may use the work of others. The Board included this clarification to highlight the special status that a highly competent and objective internal auditor has in the auditor's work as well as to caution against inappropriate overreliance on the work of management and others who would be expected to have lower degrees of competence and objectivity in assessing controls. Indeed, the Board noted that, with regard to internal control over financial reporting, internal auditors would normally be assessed as having a higher degree of competence and objectivity than management or others and that an auditor will be able to rely to a greater extent on the work of a highly competent and objective internal auditor than on work performed by others within the company.

E44. The Board concluded that the principal evidence provision is critical to preventing overreliance on the work of others in an audit of internal control over financial reporting. The requirement for the auditor to perform enough of the control testing himself or herself so that the auditor's own work provides the principal evidence for the auditor's opinion is of paramount importance to the auditor's assurance providing the level of reliability that investors expect. However, the Board also decided that the final standard should articulate clearly that the auditor's judgment about whether he or she has obtained the principal evidence required is qualitative as well as quantitative. Therefore, the standard now states, "Because the amount of work related to obtaining sufficient evidence to support an opinion about the effectiveness of controls is not susceptible to precise measurement, the auditor's judgment about whether he or she has obtained the principal evidence for the opinion will be qualitative as well as quantitative. For example, the auditor might give more weight to work performed on pervasive controls and in areas such as the control environment than on other controls, such as controls over low-risk, routine transactions."

E45. The Board also concluded that a better balance could be achieved in the standard by instructing the auditor to factor into the determination of the extent to which to use the work of others an evaluation of the nature of the controls on which others performed their procedures.

E46. Paragraph 112 of the standard provides the following factors the auditor should consider when evaluating the nature of the controls subjected to the work of others:

- The materiality of the accounts and disclosures that the control addresses and the risk of material misstatement.

- The degree of judgment required to evaluate the operating effectiveness of the control (that is, the degree to which the evaluation of the effectiveness of the control requires evaluation of subjective factors rather than objective testing).

- The pervasiveness of the control.

- The level of judgment or estimation required in the account or disclosure.

- The potential for management override of the control.

E47. As these factors increase in significance, the need for the auditor to perform his or her own work on those controls increases. As these factors decrease in significance, the auditor may rely more on the work of others. Because of the nature of controls in the control environment, however, the standard does not allow the auditor to use the work of others to reduce the amount of work he or she performs on such controls. In addition, the standard also does not allow the auditor to use the work of others in connection with the performance of walkthroughs of major classes of transactions because of the high degree of judgment required when performing them (See separate discussion in paragraphs E51 through E57).

E48. The Board decided that this approach was responsive to those who believed that the auditor should be able to use his or her judgment in determining the extent to which to use the work of others. The Board designed the requirement that the auditor's own work must provide the principal evidence for the auditor's opinion as one of the boundaries within which the auditor determines the work he or she must perform himself or herself in the audit of internal control over financial reporting. The other instructions about using the work of others provide more specific direction about how the auditor makes this determination, but allow the auditor significant flexibility to use his or her judgment to determine the work necessary to obtain the principal evidence, and to determine when the auditor can use the work of others rather than perform the work himself or herself. Although some of the directions are specific and definitive, such as the directions for the auditor to perform tests of controls in the control environment and walkthroughs himself or herself, the Board decided that these areas were of such audit importance that the auditor should always perform this testing as part of obtaining the principal evidence for his or her opinion. The Board concluded that this approach appropriately balances the use of auditor judgment and the risk of inappropriate overreliance.

E49. The Board was particularly concerned by comments that issuers might choose to reduce their internal audit staff or the extent of internal audit testing in the absence of a significant change in the proposed standard that would significantly increase the extent to which the auditor may use the work of internal auditors. The Board believes the standard makes clear that an effective internal audit function does permit the auditor to reduce the work that otherwise would be necessary.

E50. Finally, as part of clarifying the linkage between the degree of competence and objectivity of the others and the ability to use their work, the Board decided that additional clarification should be provided on the extent of testing that should be required of the work of others. The Board noted that the interaction of the auditor performing walkthroughs of every significant process and the retention of the principal evidence provision precluded the need for the auditor to test the work of others in every significant account. However, testing the work of others is an important part of an ongoing assessment of their competence and objectivity. Therefore, as part of the emphasis on the direct relationship between the assessed level of competence and objectivity to the extent of the use of the work of others, additional provisions were added discussing how the results of the testing of the work of others might affect the auditor's assessment of competence and objectivity. The Board also concluded that testing the work of others should be clearly linked to an evaluation of the quality and effectiveness of their work.

Walkthroughs

E51. The proposed standard included a requirement that the auditor perform walkthroughs, stating that the auditor should perform a walkthrough for all of the company's significant processes. In the walkthrough, the auditor was to trace all types of transactions and events, both recurring and unusual, from origination through the company's information systems until they were included in the company's financial reports. As stated in the proposed standard, walkthroughs provide the auditor with evidence to:

- Confirm the auditor's understanding of the process flow of transactions;
- Confirm the auditor's understanding of the design of controls identified for all five components of internal control over financial reporting, including those related to the prevention or detection of fraud;
- Confirm that the auditor's understanding of the process is complete by determining whether all points in the process at which misstatements related to each relevant financial statement assertion that could occur have been identified;
- Evaluate the effectiveness of the design of controls; and
- Confirm whether controls have been placed in operation.

E52. A number of commenters expressed strong support for the requirement for the auditor to perform walkthroughs as described in the proposed standard. They agreed that auditors who did not already perform the type of walkthrough described in the proposed standard should perform them as a matter of good practice. These commenters further recognized that the first-hand understanding an auditor obtains from performing these walkthroughs puts the auditor in a much better position to design an effective audit and to evaluate the quality and effectiveness of the work of others. They considered the walkthrough requirement part of "getting back to basics," which they viewed as a positive development.

E53. Some commenters expressed general support for walkthroughs as required procedures, but had concerns about the scope of the work. A number of commenters suggested that requiring walkthroughs of *all* significant processes and *all* types of transactions would result in an overwhelming and unreasonable number of walkthroughs required. Commenters made various suggestions for alleviating this problem, including permitting the auditor to determine, using broad auditor judgment, which classes of transactions to walk through or refining the scope of "all types of transactions" to include some kind of consideration of risk and materiality.

E54. Other commenters believed that required walkthroughs would result in excessive cost if the auditor were prohibited from using the work of others. These commenters suggested that the only way that required walkthroughs would be a reasonable procedure is to permit the auditor to use the work of others. Although commenters varied on whether the auditor's use of the work of others for walkthroughs should be liberal or limited, and whether it should include management or be limited to internal auditors, a large number of commenters suggested that limiting walkthroughs to only the auditor himself or herself was impractical.

E55. The Board concluded that the objectives of the walkthroughs cannot be achieved second-hand. For the objectives to be effectively achieved, the auditor must perform the walkthroughs himself or herself. Several commenters who objected to the prohibition on using the work of internal auditors for walkthroughs described situations in which internal auditors would be better able to effectively perform walkthroughs because internal auditors understood the company's business and controls better than the external auditor and because the external auditor would struggle in performing walkthroughs due to a lack of understanding. The Board observed that these commenters' perspectives support the importance of requiring the external auditor to perform walkthroughs. If auditors struggle to initially perform walkthroughs because their knowledge of the company and its controls is weak, then that situation would only emphasize the necessity for the auditor to increase his or her level of understanding. After considering the nature and extent of the procedures that would be required to achieve these objectives, the Board concluded that performing walkthroughs would be the most efficient means of doing so. The first-hand understanding the auditor will obtain of the company's processes and its controls through the walkthroughs will translate into increased effectiveness and quality throughout the rest of the audit, in a way that cannot be achieved otherwise.

E56. The Board also decided that the scope of the transactions that should be subjected to walkthroughs should be more narrowly defined. To achieve the objectives the Board intended for walkthroughs to accomplish, the auditor should not be forced to perform walkthroughs on what many commenters reasoned was an unreasonably large population. The Board decided that the auditor should be able to use judgment in considering risk and materiality to determine which transactions and events within a given significant process to walk through. As a result, the directions in the standard on determining significant processes and major classes of transactions were expanded, and the population of transactions for which auditors will be required to walk through narrowed by replacing "all types of transactions" with "major classes of transactions."

E57. Although judgments of risk and materiality are inherent in identifying major classes of transactions, the Board decided to also remove from the standard the statement, "walkthroughs are required procedures" as a means of further clarifying that auditor judgment plays an important role in determining the major classes of transactions for which to perform a walkthrough. The Board observed that leading off the discussion of walkthroughs in the standard with such a sentence could be read as setting a tone that diminished the role of judgment in selecting the transactions to walk through. As a result, the directions in the standard on performing walkthroughs begin with, "The auditor should perform at least one walkthrough for each major class of transactions…" The Board's decision to eliminate the statement "walkthroughs are required procedures" should not be viewed as an indication that performing walkthroughs are optional under the standard's directions. The Board believes the auditor might be able to achieve the objectives of a walkthrough by performing a combination of procedures, including inquiry, inspection, observation, and reperformance; however, performing a walkthrough represents the most efficient and effective means of doing so. The auditor's work on the control environment and walkthroughs is an important part of the principal evidence that the auditor must obtain himself or herself.

Small Business Issues

E58. Appendix E of the proposed standard discussed small and medium-sized company considerations. Comments were widely distributed on this topic. A number of commenters indicated that the proposed standard gave adequate 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 companies. Other commenters, particularly smaller issuers and smaller audit firms, indicated that the proposed standard needed to provide much more detail on how internal control over financial reporting could be different at a small or medium-sized issuer and how the auditor's approach could differ. Some of these commenters indicated that the concepts articulated in the Board's proposing release concerning accommodations for small and medium-sized companies were not carried through to the proposed standard itself.

E59. On the other hand, other commenters, particularly large audit firms and investors, expressed views that the proposed standard went too far in creating too much of an accommodation for small and medium-sized issuers. In fact, many believed that the proposed standard permitted those issuers to have less effective internal control over financial reporting than larger issuers, while providing guidance to auditors permitting them to perform less extensive testing at those small and medium-sized issuers than they might have at larger issuers. These commenters stressed that effective internal control over financial reporting is equally important at small and medium-sized issuers. Some commenters also expressed concerns that the guidance in proposed Appendix E appeared to emphasize that the actions of senior management, if carried out with integrity, could offset deficiencies in internal control over financial reporting, such as the lack of written policies and procedures. Because the risk of management override of controls is higher in these types of environments, such commenters were concerned that the guidance in proposed Appendix E might result in an increased fraud risk at small and medium-sized issuers. At a minimum, they argued, the interpretation of Appendix E might result in a dangerous expectation gap for users of their internal control reports. Some commenters who were of this view suggested that Appendix E be deleted altogether or replaced with a reference to the report of the Committee of Sponsoring Organizations (COSO) of the Treadway Commission, *Internal Control—Integrated Framework*, which they felt contained sufficient guidance on small and medium-sized company considerations.

E60. Striking an appropriate balance regarding the needs of smaller issuers is particularly challenging. The Board considered cautionary views about the difficulty in expressing accommodations for small and medium-sized companies without creating an inappropriate second class of internal control effectiveness and audit assurance. Further, the Board noted that the COSO framework currently provides management and the auditor with more guidance and flexibility regarding small and medium-sized companies than the Board had provided in the proposed Appendix E. As a result, the Board eliminated proposed Appendix E and replaced the appendix with a reference to COSO in paragraph 15 of the standard. The Board believes providing internal control criteria for small and medium-sized companies within the internal control framework is more appropriately within the purview of COSO. Furthermore, the COSO report was already tailored for special small and medium-sized company considerations. The Board decided that emphasizing the existing guidance within COSO was the best way of recognizing the special considerations that can and should be given to small and medium-sized companies without inappropriately weakening the standard to which these smaller entities should, nonetheless, be held. If additional tailored guidance on the internal control framework for small and medium-sized companies is needed, the Board encourages COSO, or some other appropriate body, to develop this guidance.

Evaluation of the Effectiveness of the Audit Committee

E61. The proposed standard identified a number of circumstances that, because of their likely significant negative effect on internal control over financial reporting, are significant deficiencies as well as *strong indicators* that a material weakness exists. A particularly notable significant deficiency and strong indicator of a material weakness was the ineffective oversight by the audit committee of the company's external financial reporting and internal control over financial reporting. In addition, the proposed standard required the auditor to evaluate factors related to the effectiveness of the audit committee's oversight of the external financial reporting process and the internal control over financial reporting.

E62. This provision related to evaluating the effectiveness of the audit committee was included in the proposed standard for two primary reasons. First, the Board initially decided that, because of the significant role that the audit committee has in the control environment and monitoring components of internal control over financial reporting, an ineffective audit committee is a gravely serious control weakness that is strongly indicative of a material weakness. Most auditors should have already been reaching this conclusion when confronted with an obviously ineffective audit committee. Second, highlighting the adverse consequences of an ineffective audit committee would, perhaps, further encourage weak audit committees to improve.

E63. Investors supported this provision. They expressed an expectation that the auditor would evaluate the audit committee's effectiveness and speak up if the audit committee was determined to be ineffective. Investors drew a link among restoring their confidence, audit committees having new and enhanced responsibilities, and the need for assurance that audit committees are, in fact, meeting their responsibilities.

E64. Auditors also were generally supportive of such an evaluation. However, many requested that the proposed standard be refined to clearly indicate that the auditor's responsibility to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is not a separate and distinct evaluation. Rather, the evaluation is one element of the auditor's overall understanding and assessment of the company's control environment and monitoring components. Some commenters suggested that, in addition to needing clarification of the auditor's responsibility, the auditor would have difficulty in evaluating all of the factors listed in the proposed standard, because the auditor's normal interaction with the audit committee would not provide sufficient basis to conclude on some of those factors.

E65. Issuers and some others were opposed to the auditor evaluating the effectiveness of the audit committee on the fundamental grounds that such an evaluation would represent an unacceptable conflict of interest. Several commenters shared the view that this provision would reverse an important improvement in governance and audit quality. Whereas the auditor was formerly retained and compensated by management, the Act made clear that these responsibilities should now be those of the audit committee. In this way, commenters saw a conflict of interest being remedied. Requiring the auditor to evaluate the effectiveness of the audit committee led commenters to conclude that the same kind of conflict of interest was being reestablished. These commenters also believed that the auditor would not have a sufficient basis on which to evaluate the effectiveness of the audit committee because the auditor does not have complete and free access to the audit committee, does not have appropriate expertise to evaluate audit committee members (who frequently are more experienced businesspeople than the auditor), does not have the legal expertise to make determinations about some of the specific factors listed in the proposed standard, and other shortcomings. These commenters also emphasized that the board of directors' evaluation of the audit committee is important and that the proposed standard could be read to supplant this important evaluation with that of the auditor's.

E66. The Board concluded that this provision should be retained but decided that clarification was needed to emphasize that the auditor's evaluation of the audit committee was not a separate evaluation but, rather, was made as part of the auditor's evaluation of the control environment and monitoring components of internal control over financial reporting. The Board reasoned that clarifying both this context and limitation on the auditor's evaluation of the audit committee would also address, to some degree, the conflict-of-interest concerns raised by other commenters. The Board also observed, however, that conflict is, to some extent, inherent in the duties that society expects of auditors. Just as auditors were expected in the past to challenge management when the auditor believed a material misstatement of the financial statements or material weakness in internal control over financial reporting existed, the auditor similarly is expected to speak up when he or she believes the audit committee is ineffective in its oversight.

E67. The Board decided that when the auditor is evaluating the control environment and monitoring components, if the auditor concludes that the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is ineffective, the auditor should be strongly encouraged to consider that situation a material weakness and, at a minimum, a significant deficiency. The objective of the evaluation is not to grade the effectiveness of the audit committee along a scale. Rather, in the course of performing procedures related to evaluating the effectiveness of the control environment and monitoring components, including evaluating factors related to the effectiveness of the audit committee's oversight, if the auditor concludes that the audit committee's oversight of the external financial reporting and internal control over financial reporting is ineffective, then the auditor should consider that a strong indicator of a material weakness.

E68. The Board concluded that several refinements should be made to this provision. As part of emphasizing that the auditor's evaluation of the audit committee is to be made as part of evaluating the control environment and not as a separate evaluation, the Board determined that the evaluation factors should be modified. The factors that addressed compliance with listing standards and sections of the Act were deleted, because those factors were specifically criticized in comment letters as being either outside the scope of the auditor's expertise or outside the scope of internal control over financial reporting. The Board also believed that those factors were not significant to the type of evaluation the auditor was expected to make of the audit committee. The Board decided to add the following factors, which are based closely on factors described in COSO, as relevant to evaluating those who govern, including the audit committee:

- Extent of direct and independent interaction with key members of financial management, including the chief financial officer and chief accounting officer.

- Degree to which difficult questions are raised and pursued with management and the auditor, including questions that indicate an understanding of the critical accounting policies and judgmental accounting estimates.

- Level of responsiveness to issues raised by the auditor, including those required to be communicated by the auditor to the audit committee.

E69. The Board also concluded that the standard should explicitly acknowledge that the board of directors is responsible for evaluating the effectiveness of the audit committee and that the auditor's evaluation of the control environment is not intended to supplant those evaluations. In addition, the Board concluded that, in the event the auditor determines that the audit committee's oversight is ineffective, the auditor should communicate that finding to the full board of directors. This communication should occur regardless of whether the auditor concludes that the condition represents a significant deficiency or a material weakness, and the communication should take place in addition to the normal communication requirements that attach to those deficiencies.

Definitions of Significant Deficiency and Material Weakness

E70. As part of developing the proposed standard, the Board evaluated the existing definitions of significant deficiency (which the SEC defined as being the same as a reportable condition) and material weakness to determine whether they would permit the most effective implementation of the internal control reporting requirements of the Act.

E71. AU sec. 325, *Communication of Internal Control Related Matters Noted in an Audit*, defined a material weakness as follows:

> A *material weakness* in internal control is 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.

E72. The framework that defined a material weakness focused on likelihood of and magnitude for evaluating a weakness. The Board decided that this framework would facilitate effective implementation of the Act's internal control reporting requirements; therefore, the Board's proposed definitions focused on likelihood and magnitude. However, as part of these deliberations, the Board decided that likelihood and magnitude needed to be defined in terms that would encourage more consistent application.

E73. Within the existing definition of material weakness, the magnitude of "material in relation to the financial statements" was well supported by the professional standards, SEC rules and guidance, and other literature. However, the Board decided that the definition of likelihood would be improved if it used "more than remote" instead of "relatively low level." FASB Statement No. 5, *Accounting for Contingencies* (FAS No. 5) defines "remote." The Board decided that, because auditors were familiar with the application of the likelihood definitions in FAS No. 5, using "more than remote" in the definition of material weakness would infuse the evaluation of whether a control deficiency was a material weakness with the additional consistency that the Board wanted to encourage.

E74. AU sec. 325 defined *reportable conditions* as follows:

> …matters coming to the auditor's attention that, in his judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of internal control, which could adversely affect the organization's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements.

E75. The Board observed that this definition makes the determination of whether a condition is reportable solely a matter of the auditor's judgment. The Board believed that this definition was insufficient for purposes of the Act because management also needs a definition to determine whether a deficiency is significant and that the definition should be the same as the definition used by the auditor. Furthermore, using this existing definition, the auditor's judgment could never be questioned.

E76. The Board decided that the same framework that represented an appropriate framework for defining a material weakness also should be used for defining a significant deficiency. Although auditor judgment is integral and essential to the audit process (including in determining the severity of control weaknesses), auditors, nonetheless, must be accountable for their judgments. Increasing the accountability of auditors for their judgments about whether a condition represents a significant deficiency and increasing the consistency with which those judgments are made are interrelated. Hence, the same framework of likelihood and magnitude were applied in the Board's proposed definition of significant deficiency.

E77. In applying the likelihood and magnitude framework to defining a significant deficiency, the Board decided that the "more than remote" likelihood of occurrence used in the definition of material weakness was the best benchmark. In terms of magnitude, the Board decided that "more than inconsequential" should be the threshold for a significant deficiency.

E78. A number of commenters were supportive of the definitions in the proposed standard. These commenters believed the definitions were an improvement over the previous definitions, used terms familiar to auditors, and would promote increased consistency in evaluations.

E79. Most commenters, however, objected to these definitions. The primary, over-arching objection was that these definitions set too low a threshold for the reporting of significant deficiencies. Some commenters focused on "more than remote" likelihood as the driver of an unreasonably low threshold, while others believed "more than inconsequential" in the definition of significant deficiency was the main culprit. While some commenters understood "more than inconsequential" well enough, others indicated significant concerns that this represented a new term of art that needed to be accompanied by a clear definition of "inconsequential" as well as supporting examples. Several commenters suggested retaining the likelihood and magnitude approach to a definition but suggested alternatives for likelihood (such as reasonably likely, reasonably possible, more likely than not, probable) and magnitude (such as material, significant, insignificant).

E80. Some commenters suggested that the auditing standard retain the existing definitions of material weakness and significant deficiency, consistent with the SEC's final rules implementing Section 404. In their final rules, the SEC tied management's assessment to the existing definitions of material weakness and significant deficiency (through the existing definition of a reportable condition) in AU sec. 325. These commenters suggested that, if the auditing standard used a different definition, a dangerous disconnect would result, whereby management would be using one set of definitions under the SEC's rules and auditors would be using another set under the Board's auditing standards. They further suggested that, absent rulemaking by the SEC to change its definitions, the Board should simply defer to the existing definitions.

E81. A number of other commenters questioned the reference to "a misstatement of the annual or interim financial statements" in the definitions, with the emphasis on why "interim" financial statements were included in the definition, since Section 404 required only an annual assessment of internal control over financial reporting effectiveness, made as of year-end. They questioned whether this definition implied that the auditor was required to identify deficiencies that could result in a misstatement in interim financial statements; they did not believe that the auditor should be required to plan his or her audit of internal control over financial reporting at a materiality level of the interim financial statements.

E82. The Board ultimately concluded that focusing the definitions of material weakness and significant deficiency on likelihood of misstatement and magnitude of misstatement provides the best framework for evaluating deficiencies. Defaulting to the existing definitions would not best serve the public interest nor facilitate meaningful and effective implementation of the auditing standard.

E83. The Board observed that the SEC's final rules requiring management to report on internal control over financial reporting define material weakness, for the purposes of the final rules, as having "the same meaning as the definition under GAAS and attestation standards." Those rules state:

> The term "significant deficiency" has the same meaning as the term "reportable condition" as used in AU §325 and AT§501. The terms "material weakness" and "significant deficiency" both represent deficiencies in the design or operation of internal control that could adversely affect a company's ability to record, process, summarize and report financial data consistent with the assertions of management in the company's financial statements, with a "material weakness" constituting a greater deficiency than a "significant deficiency." Because of this relationship, it is our judgment that an aggregation of significant deficiencies could constitute a material weakness in a company's internal control over financial reporting.[42/]

E84. The Board considered the SEC's choice to cross-reference to generally accepted auditing standards (GAAS) and the attestation standards as the means of defining these terms, rather than defining them outright within the final rules, noteworthy as it relates to the question of whether any disconnect could result between auditors' and managements' evaluations if the Board changed the definitions in its standards. Because the standard changes the definition of these terms within the interim standards, the Board believes the definitions are, therefore, changed for both auditors' and managements' purposes.

[42/] See footnote 73 to *Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports,* Securities and Exchange Commission Release No. 33-8238 (June 5, 2003) [68 FR 36636].

E85. The Board noted that commenters who were concerned that the definitions in the proposed standard set too low of a threshold for significant deficiencies and material weaknesses believed that the proposed standard required that each control deficiency be evaluated in isolation. The intent of the proposed standard was that control deficiencies should first be evaluated individually; the determination as to whether they are significant deficiencies or material weaknesses should be made considering the effects of compensating controls. The effect of compensating controls should be taken into account when assessing the likelihood of a misstatement occurring and not being prevented or detected. The proposed standard illustrated this type of evaluation, including the effect of compensating controls when assessing likelihood, in the examples in Appendix D. Based on the comments received, however, the Board determined that additional clarification within the standard was necessary to emphasize the importance of considering compensating controls when evaluating the likelihood of a misstatement occurring. As a result, the note to paragraph 10 was added.

E86. The Board concluded that considering the effect of compensating controls on the likelihood of a misstatement occurring and not being prevented or detected sufficiently addressed the concerns that the definitions set too low a threshold. For example, several issuer commenters cited concerns that the proposed definitions precluded a rational cost-benefit analysis of whether to correct a deficiency. These issuers believed they would be compelled to correct deficiencies (because the deficiencies would be considered to be at least significant deficiencies) in situations in which management had made a previous conscious decision that the costs of correcting the deficiency outweighed the benefits. The Board observed that, in cases in which management has determined not to correct a known deficiency based on a cost-benefit analysis, effective compensating controls usually lie at the heart of management's decision. The standard's use of "likelihood" in the definition of a significant deficiency or material weakness accommodates such a consideration of compensating controls. If a deficiency is effectively mitigated by compensating controls, then the likelihood of a misstatement occurring and not being prevented or detected may very well be remote.

E87. The Board disagreed with comments that "more than inconsequential" was too low a threshold; however, the Board decided the term "inconsequential" needed additional clarity. The Board considered the term "inconsequential" in relation to the SEC's guidance on audit requirements and materiality. Section 10A(b)(1)(B)[43/] describes the auditor's communication requirements when the auditor detects or otherwise becomes aware of information indicating that an illegal act has or may have occurred, "unless the illegal act is clearly inconsequential." Staff Accounting Bulletin (SAB) No. 99, *Materiality*, provides the most recent and definitive guidance on the concept of materiality as it relates to the financial reporting of a public company. SAB No. 99 uses the term "inconsequential" in several places to draw a distinction between amounts that

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[43/] See Section 10A of the Securities Exchange Act of 1934, 15 U.S.C., 78j-1.

are not material. SAB No. 99 provides the following guidance to assess the significance of a misstatement:

> Though the staff does not believe that registrants need to make finely calibrated determinations of significance with respect to immaterial items, plainly it is "reasonable" to treat misstatements whose effects are clearly inconsequential differently than more significant ones.

E88. The discussion in the previous paragraphs provided the Board's context for using "material" and "more than inconsequential" for the magnitude thresholds in the standard's definitions. "More than inconsequential" indicates an amount that is less than material yet has significance.

E89. The Board also considered the existing guidance in the Board's interim standards for evaluating materiality and accumulating audit differences in a financial statement audit. Paragraph .41 of AU sec. 312, *Audit Risk and Materiality in Conducting an Audit,* states:

> In aggregating likely misstatements that the entity has not corrected, pursuant to paragraphs .34 and .35, the auditor may designate an amount below which misstatements need not be accumulated. This amount should be set so that any such misstatements, either individually or when aggregated with other such misstatements, would not be material to the financial statements, after the possibility of further undetected misstatements is considered.

E90. The Board considered the discussion in AU sec. 312 that spoke specifically to evaluating differences individually *and in the aggregate*, as well as to considering the possibility of additional undetected misstatements, important distinguishing factors that should be carried through to the evaluation of whether a control deficiency represents a significant deficiency because the magnitude of the potential misstatement is more than inconsequential.

E91. The Board combined its understanding of the salient concepts in AU sec. 312 and the SEC guidance on materiality to develop the following definition of inconsequential:

> A misstatement is *inconsequential* if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, either individually or when aggregated with other misstatements, would clearly be immaterial to the financial statements. If a reasonable person could not reach such a conclusion regarding a particular misstatement, that misstatement is *more than inconsequential.*

E92. Finally, the inclusion of *annual or interim financial statements* in the definitions rather than just "annual financial statements" was intentional and, in the Board's opinion, closely aligned with the spirit of what Section 404 seeks to accomplish. However, the Board decided that this choice needed clarification within the auditing standard. The Board did not intend the inclusion of the interim financial statements in the definition to require the auditor to perform *an audit of internal control over financial reporting* at each interim date. Rather, the Board believed that the SEC's definition of internal control over financial reporting included all financial reporting that a public company makes publicly available. In other words, internal control over financial reporting includes controls over the preparation of annual and quarterly financial statements. Thus, an evaluation of internal control over financial reporting as of year-end encompasses controls over the annual financial reporting and quarterly financial reporting as such controls exist at that point in time.

E93. Paragraphs 76 and 77 of the standard clarify this interpretation, as part of the discussion of the period-end financial reporting process. The period-end financial reporting process includes procedures to prepare both annual and quarterly financial statements.

Strong Indicators of Material Weaknesses and DeFacto Significant Deficiencies

E94. The proposed standard identified a number of circumstances that, because of their likely significant negative effect on internal control over financial reporting, are significant deficiencies as well as strong indicators that a material weakness exists. The Board developed this list to promote increased rigor and consistency in auditors' evaluations of weaknesses. For the implementation of Section 404 of the Act to achieve its objectives, the public must have confidence that all material weaknesses that exist as of the company's year-end will be publicly reported. Historically, relatively few material weaknesses have been reported by the auditor to management and the audit committee. That condition is partly due to the nature of a financial statement audit. In an audit of only the financial statements, the auditor does not have a detection responsibility for material weaknesses in internal control; such a detection responsibility is being newly introduced for all public companies through Sections 103 and 404 of the Act. However, the Board was concerned about instances in which auditors had identified a condition that should have been, but was not, communicated as a material weakness. The intention of including the list of strong indicators of material weaknesses in the proposed standard was to bring further clarity to conditions that were likely to be material weaknesses in internal control and to create more consistency in auditors' evaluations.

E95. Most commenters were generally supportive of a list of significant deficiencies and strong indicators of the existence of material weaknesses. They believed such a list provided instructive guidance to both management and the auditor. Some commenters, however, disagreed with the proposed approach of providing such a list. They believed that the determination of the significance of a deficiency should be left entirely to auditor judgment. A few commenters requested clarification of the term "strong indicator" and specific guidance on how and when a "strong indicator" could be overcome. A number of commenters expressed various concerns with individual circumstances included in the list.

- *Restatement of previously issued financial statements to reflect the correction of a misstatement*. Some commenters expressed concern about the kinds of restatements that would trigger this provision. A few mentioned the specific instance in which the restatement reflected the SEC's subsequent view of an accounting matter when the auditor, upon reevaluation, continued to believe that management had reasonable support for its original position. They believed this specific circumstance would not necessarily indicate a significant deficiency in internal control over financial reporting. Others commented that a restatement of previously issued financial statements would indicate a significant deficiency and strong indicator of a material weakness *in the prior period* but not necessarily in the current period.

- *Identification by the auditor of a material misstatement in financial statements in the current period that was not initially identified by the company's internal control over financial reporting (even if management subsequently corrects the misstatement)*. Several commenters, issuers and auditors alike, expressed concern about including this circumstance on the list. They explained that, frequently, management is completing the preparation of the financial statements at the same time that the auditor is completing his or her auditing procedures. In the face of this "strong indicator" provision, a lively debate of "who found it first" would ensue whenever the auditor identifies a misstatement that management subsequently corrects. Another argument is that the company's controls would have detected a misstatement identified by the auditor if the controls had an opportunity to operate (that is, the auditor performed his or her testing before the company's controls had an opportunity to operate). Several issuers indicated that they would prevent this latter situation by delaying the auditor's work until the issuers had clearly completed their entire period-end financial reporting process – a delay they viewed as detrimental.

- *For larger, more complex entities, the internal audit function or the risk assessment function is ineffective*. Several commenters asked for specific factors the auditor was expected to use to assess the effectiveness of these functions.

- *For complex entities in highly regulated industries, an ineffective regulatory compliance function.* Several commenters, particularly issuers in highly regulated industries, objected to the inclusion of this circumstance because they believed this to be outside the scope of internal control over financial reporting. (They agreed that this would be an internal control-related matter, but one that falls into operating effectiveness and compliance with laws and regulations, not financial reporting.) Many of these commenters suggested that this circumstance be deleted from the list altogether. Fewer commenters suggested that this problem could be addressed by simply clarifying that this circumstance is limited to situations in which the ineffective regulatory function relates solely to those aspects for which related violations of laws and regulations could have a direct and material effect on the financial statements.

- *Identification of fraud of any magnitude on the part of senior management*. Several commenters expressed concern that the inclusion of this circumstance created a detection responsibility for the auditor such that the auditor would have to plan and perform procedures to detect fraud *of any magnitude* on the part of senior management. Others expressed concern that identification of fraud on the part of senior management by the company's system of internal control over financial reporting might indicate that controls were operating effectively rather than indicating a significant deficiency or material weakness. Still others requested clarification on how to determine who constituted "senior management."

E96. A couple of commenters also suggested that an ineffective control environment should be added to the list.

E97. The Board concluded that the list of significant deficiencies and strong indicators of material weakness should be retained. Such a list will promote consistency in auditors' and managements' evaluations of deficiencies consistent with the definitions of significant deficiency and material weakness. The Board also decided to retain the existing structure of the list. Although the standard leaves auditor judgment to determine whether those deficiencies are material weaknesses, the existence of one of the listed deficiencies is by definition a significant deficiency. Furthermore, the "strong indicator" construct allows the auditor to factor extenuating or unique circumstances into the evaluation and possibly to conclude that the situation does not represent a material weakness, rather, only a significant deficiency.

E98. The Board decided that further clarification was not necessary within the standard itself addressing specifically how and when a "strong indicator" can be overcome. The term "strong indicator" was selected as opposed to the stronger "presumption" or other such term precisely because the Board did not intend to provide detailed instruction on how to overcome such a presumption. It is, nevertheless, the Board's view that auditors should be biased toward considering the listed circumstances as material weaknesses.

E99. The Board decided to clarify several circumstances included in the list:

- *Restatement of previously issued financial statements to reflect the correction of a misstatement*. The Board observed that the circumstance in which a restatement reflected the SEC's subsequent view of an accounting matter, when the auditor concluded that management had reasonable support for its original position, might present a good example of only a significant deficiency and not a material weakness. However, the Board concluded that requiring this situation to, nonetheless, be considered by definition a significant deficiency is appropriate, especially considering that the primary result of the circumstance being considered a significant deficiency is the communication of the matter to the audit committee. Although the audit committee might already be well aware of the circumstances of any restatement, a restatement to reflect the SEC's view on an accounting matter at least has implications for the quality of the company's accounting principles, which is already a required communication to the audit committee.

With regard to a restatement being a strong indicator of a material weakness in the prior period but not necessarily the current period, the Board disagreed with these comments. By virtue of the restatement occurring during the current period, the Board views it as appropriate to consider that circumstance a strong indicator that a material weakness existed during the current period. Depending on the circumstances of the restatement, however, the material weakness may also have been corrected during the current period. The construct of the standard does not preclude management and the auditor from determining that the circumstance was corrected prior to year-end and, therefore, that a material weakness did not exist at year-end. The emphasis here is that the circumstance is a strong indicator that a material weakness exists; management and the auditor will separately need to determine whether it has been corrected. The Board decided that no further clarification was needed in this regard.

- *Identification by the auditor of a material misstatement in financial statements in the current period that was not initially identified by the company's internal control over financial reporting (even if management subsequently corrects the misstatement)*. Regarding the "who-found-it-first" dilemma, the Board recognizes that this circumstance will present certain implementation challenges. However, the Board decided that none of those challenges were so significant as to require eliminating this circumstance from the list.

  When the Board developed the list of strong indicators, the Board observed that it is not uncommon for the financial statement auditor to identify material misstatements in the course of the audit that are corrected by management prior to the issuance of the company's financial statements. In some cases, management has relied on the auditor to identify misstatements in certain financial statement items and to propose corrections in amount, classification, or disclosure. With the introduction of the requirement for management and the auditor to report on the effectiveness of internal control over financial reporting, it becomes obvious that this situation is unacceptable, unless management is willing to accept other than an unqualified report on the internal control effectiveness. (This situation also raises the question as to the extent management may rely on the annual audit to produce accurate and fair financial statements without impairing the auditor's independence.) This situation is included on the list of strong indicators because the Board believes it will encourage management and auditors to evaluate this situation with intellectual honesty and to recognize, first, that the company's internal control should provide reasonable assurance that the company's financial statements are presented fairly in accordance with generally accepted accounting principles.

Timing might be a concern for some issuers. However, to the extent that management takes additional steps to ensure that the financial information is correct prior to providing it to their auditors, this may, at times, result in an improved control environment. When companies and auditors work almost simultaneously on completing the preparation of the annual financial statements and the audit, respectively, the role of the auditor can blur with the responsibility of management. In the year-end rush to complete the annual report, some companies might have come to rely on their auditors as a "control" to further ensure no misstatements are accidentally reflected in the financial statements. The principal burden seems to be for management's work schedule and administration of their financial reporting deadlines to allow the auditor sufficient time to complete his or her procedures.

Further, if the auditor initially identified a material misstatement in the financial statements but, given the circumstances, determined that management ultimately would have found the misstatement, the auditor could determine that the circumstance was a significant deficiency but not a material weakness. The Board decided to retain the provision that this circumstance is at least a significant deficiency because reporting such a circumstance to the audit committee would always be appropriate.

- *For larger, more complex entities, the internal audit function or the risk assessment function is ineffective*. Relatively few commenters requested clarification on how to evaluate these functions. The Board expects that most auditors will not have trouble making this evaluation. Similar to the audit committee evaluation, this evaluation is not a separate evaluation of the internal audit or risk assessment functions but, rather, is a way of requiring the auditor to speak up if either of these functions is obviously ineffective at an entity that needs them to have an effective monitoring or risk assessment component. Unlike the audit committee discussion, most commenters seemed to have understood that this was the context for the internal audit and risk assessment function evaluation. Nonetheless, the Board decided to add a clarifying note to this circumstance emphasizing the context.

- *For complex entities in highly regulated industries, an ineffective regulatory compliance function*. The Board decided that this circumstance, as described in the proposed standard, would encompass aspects that are outside internal control over financial reporting (which would, of course, be inappropriate for purposes of this standard given its definition of internal control over financial reporting). The Board concluded that this circumstance should be retained, though clarified, to only apply to those aspects of an ineffective regulatory compliance function that could have a material effect on the financial statements.

- *Identification of fraud of any magnitude on the part of senior management.* The Board did not intend to create any additional detection responsibility for the auditor; rather, it intended that this circumstance apply to fraud on the part of senior management that came to the auditor's attention, regardless of amount. The Board decided to clarify the standard to make this clear. The Board noted that identification of fraud by the company's system of internal control over financial reporting might indicate that controls were operating effectively, except when that fraud involves senior management. Because of the critical role of tone-at-the-top in the overall effectiveness of the control environment and due to the significant negative evidence that fraud of any magnitude on the part of senior management reflects on the control environment, the Board decided that it is appropriate to include this circumstance in the list, regardless of whether the company's controls detected the fraud. The Board also decided to clarify who is included in "senior management" for this purpose.

E100. The Board agreed that an ineffective control environment was a significant deficiency and a strong indicator that a material weakness exists and decided to add it to the list.

Independence

E101. The proposed standard explicitly prohibited the auditor from accepting an engagement to provide an internal control-related service to an audit client that has not been specifically pre-approved by the audit committee. In other words, the audit committee would not be able to pre-approve internal control-related services as a category. The Board did not propose any specific guidance on permissible internal control-related services in the proposed standard but, rather, indicated its intent to conduct an in-depth evaluation of independence requirements in the future and highlighted its ability to amend the independence information included in the standard pending the outcome of that analysis.

E102. Comments were evenly split among investors, auditors, and issuers who believed the existing guidance was sufficient versus those who believed the Board should provide additional guidance. Commenters who believed existing guidance was sufficient indicated that the SEC's latest guidance on independence needed to be given more time to take effect given its recency and because existing guidance was clear enough. Commenters who believed more guidance was necessary suggested various additions, from more specificity about permitted and prohibited services to a sweeping ban on any internal control-related work for an audit client. Other issuers commented about auditors participating in the Section 404 implementation process at their audit clients in a manner that could be perceived as affecting their independence.

E103. Some commenters suggested that the SEC should change the pre-approval requirements on internal control-related services to specific pre-approval. Another commenter suggested that specific pre-approval of all internal control-related services would pose an unreasonable burden on the audit committee and suggested reverting to pre-approval by category.

E104. The Board clearly has the authority to set independence standards as it may deem necessary or appropriate in the public interest or for the protection of investors. Given ongoing concerns about the appropriateness of auditors providing these types of services to audit clients, the fact-specific nature of each engagement, and the critical importance of ongoing audit committee oversight of these types of services, the Board continues to believe that specific pre-approval of internal control-related services is a logical step that should not pose a burden on the audit committee beyond that which effective oversight of financial reporting already entails. Therefore, the standard retains this provision unchanged.

Requirement for Adverse Opinion When a Material Weakness Exists

E105. The existing attestation standard (AT sec. 501) provides that, when the auditor has identified a material weakness in internal control over financial reporting, depending on the significance of the material weakness and its effect on the achievement of the objectives of the control criteria, the auditor may qualify his or her opinion ("except for the effect of the material weakness, internal control over financial reporting was effective") or express an adverse opinion ("internal control over financial reporting was not effective").

E106. The SEC's final rules implementing Section 404 state that, "Management is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting." In other words, in such a case, management must conclude that internal control over financial reporting is not effective (that is, a qualified or "except-for" conclusion is not acceptable).

E107. The Board initially decided that the reporting model for the auditor should follow the required reporting model for management. Therefore, because management is required to express an "adverse" conclusion in the event a material weakness exists, the auditor's opinion also must be adverse. The proposed standard did not permit a qualified audit opinion in the event of a material weakness.

E108. Comments received on requiring an adverse opinion when a material weakness exists were split. A large number affirmed that this seemed to be the only logical approach, based on a philosophical belief that if a material weakness exists, then internal control over financial reporting is ineffective. These commenters suggested that permitting a qualified opinion would be akin to creating another category of control deficiency—material weaknesses that were really material (resulting in an adverse opinion) and material weaknesses that weren't so material (resulting in a qualified opinion).

E109. A number of commenters agreed that the auditor's report must follow the same model as management' reporting, but they believe strongly that the SEC's guidance for management accommodated either a qualified or adverse opinion when a material weakness existed.

E110. These commenters cited Section II.B.3.c of the SEC Final Rule and related footnote no. 72:

> The final rules therefore preclude management from determining that a company's internal control over financial reporting is effective if it identifies one or more material weaknesses in the company's internal control over financial reporting. This is consistent with interim attestation standards. See AT sec. 501.

E111. They believe this reference to the interim attestation standard in the SEC Final Rule is referring to paragraph .37 of AT sec. 501, which states, in part,

> Therefore, the presence of a material weakness will preclude the practitioner from concluding that the entity has effective internal control. However, depending on the significance of the material weakness and its effect on the achievement of the objectives of the control criteria, the practitioner may qualify his or her opinion (that is, express an opinion that internal control is effective "except for" the material weakness noted) or may express an adverse opinion.

E112. Their reading of the SEC Final Rule and the interim attestation standard led them to conclude that it would be appropriate for the auditor to express either an adverse opinion or a qualified "except-for" opinion about the effectiveness of the company's internal control over financial reporting depending on the circumstances.

E113. Some commenters responded that they thought a qualified opinion would be appropriate in certain cases, such as an acquisition close to year-end (too close to be able to assess controls at the acquiree).

E114. After additional consultation with the SEC staff about this issue, the Board decided to retain the proposed reporting model in the standard. The primary reason for that decision was the Board's continued understanding that the SEC staff would expect only an adverse conclusion from management (not a qualified conclusion) in the event a material weakness existed as of the date of management's report.

E115. The commenters who suggested that a qualified opinion should be permitted in certain circumstances, such as an acquisition close to year-end, were essentially describing scope limitations. The standard permits a qualified opinion, a disclaimer of opinion, or withdrawal from the engagement if there are restrictions on the scope of the engagement. As it relates specifically to acquisitions near year-end, this is another case in which the auditor's model needs to follow the model that the SEC sets for management. The standard added a new paragraph to Appendix B permitting the auditor to limit the scope of his or her work (without referring to a scope limitation in the auditor's report) in the same manner that the SEC permits management to limit its assessment. In other words, if the SEC permits management to exclude an entity acquired late in the year from a company's assessment of internal control over financial reporting, then the auditor could do the same.

Rotating Tests of Controls

E116. The proposed standard directed the auditor to perform tests of controls on "relevant assertions" rather than on "significant controls." To comply with those requirements, the auditor would be required to apply tests to those controls that are important to presenting each relevant assertion in the financial statements. The proposed standard emphasized controls that affect relevant assertions because those are the points at which misstatements could occur. However, it is neither necessary to test all controls nor to test redundant controls (unless redundancy is itself a control objective, as in the case of certain computer controls). Thus, the proposed standard encouraged the auditor to identify and test controls that addressed the primary areas in which misstatements could occur, yet limited the auditor's work to only the necessary controls.

E117. Expressing the extent of testing in this manner also simplified other issues involving extent of testing decisions from year to year (the so-called "rotating tests of controls" issue). The proposed standard stated that the auditor should vary testing from year to year, both to introduce unpredictability into the testing and to respond to changes at the company. However, the proposed standard maintained that each year's audit must stand on its own. Therefore, the auditor must obtain evidence of the effectiveness of controls over all relevant assertions related to all significant accounts and disclosures every year.

E118. Auditors and investors expressed support for these provisions as described in the proposed standard. In fact, some commenters compared the notion of rotating tests of control in an audit of internal control over financial reporting to an auditor testing accounts receivable only once every few years in a financial statement audit. Permitting so-called rotation of testing would compromise the auditor's ability to obtain reasonable assurance that his or her opinion was correct.

E119. Others, especially issuers concerned with limiting costs, strongly advocated some form of rotating tests of controls. Some commenters suggested that the auditor should have broad latitude to perform some cursory procedures to determine whether any changes had occurred in controls and, if not, to curtail any further testing in that area. Some suggested that testing as described in the proposed standard should be required in the first year of the audit (the "baseline" year) and that in subsequent years the auditor should be able to reduce the required testing. Others suggested progressively less aggressive strategies for reducing the amount of work the auditor should be required to perform. In fact, several commenters (primarily internal auditors) described "baselining" controls as an important strategy to retain. They argued, for example, that IT application controls, once tested, could be relied upon (without additional testing) in subsequent years as long as general controls over program changes and access controls were effective and continued to be tested.

E120. The Board concluded that each year's audit must stand on its own. Cumulative audit knowledge is not to be ignored; some natural efficiencies will emerge as the auditor repeats the audit process. For example, the auditor will frequently spend less time to obtain the requisite understanding of the company's internal control over financial reporting in subsequent years compared with the time necessary in the first year's audit of internal control over financial reporting. Also, to the extent that the auditor has previous knowledge of control weaknesses, his or her audit strategy should, of course, reflect that knowledge. For example, a pattern of mistakes in prior periods is usually a good indicator of the areas in which misstatements are likely to occur. However, the absence of fraud in prior periods is not a reasonable indicator of the likelihood of misstatement due to fraud.

E121. However, the auditor needs to test controls every year, regardless of whether controls have obviously changed. Even if nothing else changed about the company – no changes in the business model, employees, organization, etc. – controls that were effective last year may not be effective this year due to error, complacency, distraction, and other human conditions that result in the inherent limitations in internal control over financial reporting.

E122. What several commenters referred to as "baselining" (especially as it relates to IT controls) is more commonly referred to by auditors as "benchmarking." This type of testing strategy for application controls is not precluded by the standard. However, the Board believes that providing a description of this approach is beyond the scope of this standard. For these reasons, the standard does not address it.

Mandatory Integration with the Audit of the Financial Statements

E123. Section 404(b) of the Act provides that the auditor's attestation of management's assessment of internal control shall not be the subject of a separate engagement. Because the objectives of and work involved in performing both an attestation of management's assessment of internal control over financial reporting and an audit of the financial statements are closely interrelated, the proposed auditing standard introduced an integrated audit of internal control over financial reporting and audit of financial statements.

E124. However, the proposed standard went even further. Because of the potential significance of the information obtained during the audit of the financial statements to the auditor's conclusions about the effectiveness of internal control over financial reporting, the proposed standard stated that the auditor could not audit internal control over financial reporting without also auditing the financial statements. (However, the proposed standard retained the auditor's ability to audit *only* the financial statements, which might be necessary in the case of certain initial public offerings.)

E125. Although the Board solicited specific comment on whether the auditor should be prohibited from performing an audit of internal control over financial reporting without also performing an audit of the financial statements, few commenters focused on the significance of the potentially negative evidence that would be obtained during the audit of the financial statements or the implications of this prohibition. Most commenters focused on the wording of Section 404(b), which indicates that the auditor's attestation of management's assessment of internal control over financial reporting shall not be the subject of a separate engagement. Based on this information, most commenters saw the prohibition in the proposed standard as superfluous and benign.

E126. Several commenters recognized the importance of the potentially negative evidence that might be obtained as part of the audit of the financial statements and expressed strong support for requiring that an audit of financial statements be performed to audit internal control over financial reporting.

E127. Others recognized the implications of this prohibition and expressed concern: What if a company wanted or needed an opinion on the effectiveness of internal control over financial reporting as of an interim date? For the most part, these commenters (primarily issuers) objected to the implication that an auditor would have to audit a company's financial statements as of an interim date to enable him or her to audit and report on its internal control over financial reporting as of that same interim date. Other issuers expressed objections related to their desires to engage one auditor to provide an opinion on the effectiveness of internal control over financial reporting and another to audit the financial statements. Others requested clarification about which guidance would apply when other forms of internal control work were requested by companies.

E128. The Board concluded that an auditor should perform an audit of internal control over financial reporting only when he or she has also audited company's financial statements. The auditor *must* audit the financial statements to have a high level of assurance that his or her conclusion on the effectiveness of internal control over financial reporting is correct. Inherent in the reasonable assurance provided by the auditor's opinion on internal control over financial reporting is a responsibility for the auditor to plan and perform his or her work to obtain reasonable assurance that material weaknesses, if they exist, are detected. As previously discussed, this standard states that the identification by the auditor of a *material misstatement* in the financial statements that was not initially identified by the company's internal control over financial reporting, is a strong indicator of a material weakness. Without performing a financial statement audit, the auditor would not have reasonable assurance that he or she had detected all material misstatements. The Board believes that allowing the auditor to audit internal control over financial reporting without also auditing the financial statements would not provide the auditor with a high level of assurance and would mislead investors in terms of the level of assurance obtained.

E129. In response to other concerns, the Board noted that an auditor can report on the effectiveness of internal control over financial reporting using existing AT sec. 501 for purposes other than satisfying the requirements of Section 404. This standard supersedes AT sec. 501 only as it relates to complying with Section 404 of the Act.

E130. Although reporting under the remaining provisions of AT sec. 501 is currently permissible, the Board believes reports issued for public companies under the remaining provisions of AT sec. 501 will be infrequent. In any event, additional rulemaking might be necessary to prevent confusion that might arise from reporting on internal control engagements under two different standards. For example, explanatory language could be added to reports issued under AT sec. 501 to clarify that an audit of financial statements was not performed in conjunction with the attestation on internal control over financial reporting and that such a report is not the report resulting from an audit of internal control over financial reporting performed in conjunction with an audit of the financial statements under this standard. This report modification would alert report readers, particularly if such a report were to appear in an SEC filing or otherwise be made publicly available, that the assurance obtained by the auditor in that engagement is different from the assurance that would have been obtained by the auditor for Section 404 purposes. Another example of the type of change that might be necessary in separate rulemaking to AT sec. 501 would be to supplement the performance directions to be comparable to those in this standard. Auditors should remain alert for additional rulemaking by the Board that affects AT sec. 501.

(b) Statutory Basis

The statutory basis for the proposed rule is Title I of the Act.

B. Board's Statement on Burden on Competition

The Board does not believe that the proposed rule will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. Pursuant to Sections 404 and 103 of the Act, each registered public accounting firm that prepares or issues the audit report for an issuer shall attest to, and report on, the assessment of internal control made by the management of the issuer. Although compliance with the proposed rule will impose costs, those costs are necessary in order to implement the requirements of Sections 103 and 404 of the Act and will be imposed in a way that does not disproportionately or unnecessarily burden competition.

C. Board's Statement on Comments on the Proposed Rule Received from Members, Participants or Others

The Board released the proposed rule for public comment in PCAOB Release No. 2003-017 (October 7, 2003). A copy of PCAOB Release No. 2003-017 and the comment letters received in response to the PCAOB's request for comment are available on the PCAOB's web site at www.pcaobus.org. The Board received 193 written comments. The Board has clarified and modified certain aspects of the proposed rule and the instructions to the related form in response to comments it received, as discussed in Appendix E, *Background and Basis for Conclusions,* to the proposed rule.

III. Date of Effectiveness of the Proposed Rule and Timing for Commission Action

Within 60 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to

90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Board consents the Commission will:

(a) by order approve such proposed rule; or

(b) institute proceedings to determine whether the proposed rule should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule is consistent with the requirements of Title I of the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule that are filed with the Commission, and all written communications relating to the proposed rule between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the PCAOB. All submissions should refer to File No. PCAOB-2004-03 and should be submitted within [ ] days.

By the Commission.

Secretary

PCAOB
Public Company Accounting Oversight Board

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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 PCAOB Rulemaking Docket Matter No. 008

Summary: The Public Company Accounting Oversight Board (the "Board" or "PCAOB") has proposed an Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements.* If adopted, this standard would be the standard on attestation engagements referred to in Section 404(b) as well as Section 103(a)(2)(A) of the Sarbanes-Oxley Act of 2002.

Public Comment: Interested persons may submit written comments to the Board. Such comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments may also be submitted by e-mail to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 008 in the subject or reference line and should be received by the Board no later than 5:00 PM (EST) on November 21, 2003.

Board Contacts: Thomas Ray, Deputy Chief Auditor (202/207-9112; rayt@pcaobus.org), Laura Phillips, Assistant Chief Auditor (202/207-9111; phillipsl@pcaobus.org).

Section 404(a) of the Sarbanes-Oxley Act of 2002 (the Act), and the Securities and Exchange Commission's ("SEC") related implementing rules,[1/] require the management of a public company to assess the effectiveness of the company's internal control over financial reporting, as of the end of the company's most recent fiscal year. Section 404(a) of the Act also requires management to include in the company's annual report to shareholders management's conclusion as a result of that assessment about whether the company's internal control is effective. Companies considered accelerated filers (seasoned U.S. companies with public float exceeding $75 million) are required to comply with the internal control reporting and disclosure requirements of Section 404(a) of the Act for fiscal years ending on or after June 15, 2004. Other companies (including smaller companies, foreign private issuers and companies with only registered debt securities) have until fiscal years ending on or after April 15, 2005, to comply with these internal control reporting and disclosure requirements.

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.

An attestation, in a general sense, is an expert's communication of a conclusion about the reliability of someone else's assertion. For example, a financial statement audit is a form of attestation. In a financial statement audit, the auditor attests to the fairness of a company's financial statements, which are assertions by management regarding the financial performance and financial condition of the company. To accomplish this task, the auditor evaluates the process management uses to prepare the company's financial statements and gathers evidence to support or refute the assertions. Similarly, the auditor's attestation on management's assessment of the effectiveness of the company's internal control over financial reporting involves evaluating management's assessment process and gathering evidence regarding the design and operating effectiveness of the company's internal control, determining whether that evidence supports or refutes management's assessment, and opining as to whether management's assessment is fair.

When the Board adopted its interim attestation standards in Rule 3300T on a transitional basis, the Board adopted a pre-existing standard governing an auditor's

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[1/] See Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities and Exchange Commission Release No. 33-8238 (June 5, 2003) [68 FR 36636].

attestation on internal control. As part of the Board's process of evaluating that pre-existing standard, the Board convened a public roundtable discussion on July 29, 2003 to discuss issues and hear views related to reporting on internal control. The participants at the roundtable included representatives from public companies, accounting firms, investor groups and regulatory organizations. As a result of comments made at the roundtable, advice from the Board's staff, and other input the Board received, the Board determined that the pre-existing standard governing an auditor's attestation on internal control was insufficient for purposes of effectively implementing the requirements of Section 404 of the Act, and for the Board to appropriately discharge the Board's standard-setting obligations under Section 103(a) of the Act. In response, the Board developed this proposed auditing standard.

An Integrated Audit of the Financial Statements and Internal Control Over Financial Reporting

Section 404(b) of the Act provides that the auditor's attestation of management's assessment of internal control shall not be the subject of a separate engagement. Because the objectives of and work involved in performing both an attestation of management's assessment of internal control and an audit of the financial statements are closely interrelated, the proposed auditing standard introduces an integrated audit of internal control and financial statements. The proposed auditing standard is an integrated standard, addressing both the work that is required to audit internal control over financial reporting and the relationship of that audit to the audit of the financial statements. Nevertheless, the integrated audit results in two opinions: one on internal control over financial reporting and one on the financial statements, which may be expressed in a combined report or in separate reports. Throughout the proposed standard, the auditor's attestation of management's assessment of the effectiveness of internal control over financial reporting is referred to as the "audit of internal control over financial reporting."

To conduct and report on the results of an audit of internal control over financial reporting pursuant to the proposed standard, the auditor also would be required to audit the company's financial statements. That is because of the potential significance of the information that might be obtained during the audit of the financial statements to the auditor's conclusions about the effectiveness of internal control.

In evaluating the proposed standard, the Board seeks comments on 31 questions. The Board requests respondents to answer the questions and provide explanations as to why they agree or disagree with the positions the Board has taken in the proposed standard. The first three of these questions are presented below.

Questions regarding an integrated audit of the financial statements and internal control over financial reporting:

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?

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?

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?

Internal Control Over Financial Reporting

Internal control is a process designed to provide reasonable assurance regarding the achievement of a company's objectives in the areas of financial reporting reliability, operating efficiency and effectiveness, and compliance with applicable laws and regulations. The SEC's rules implementing Section 404(a) of the Act, and the Board's proposed auditing standard, focus on those objectives exclusively related to the reliability of a company's external financial reporting. This subset of internal control is commonly referred to as *internal control over financial reporting*.

Internal control over financial reporting consists of company policies and procedures that are designed and operated to provide reasonable assurance – that is, a high but not absolute level of assurance – about the reliability of a company's financial reporting and its process for preparing and fairly presenting financial statements in accordance with generally accepted accounting principles. It includes policies and procedures that pertain to the maintenance of accounting records, the authorization of receipts and disbursements, and the safeguarding of assets.

Management is required to base its assessment of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework established by a body of experts that followed due-process procedures to develop the framework. In the United States, the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission has published *Internal Control – Integrated Framework*. Known as the "COSO Report," it provides a suitable framework for purposes of management's assessment. Because of the frequency with which management of public companies is expected to use COSO as the framework for the assessment, the directions in the proposed standard are based on the COSO framework. Other suitable frameworks have been published in other countries and likely will be published in the future. Although different frameworks may not contain exactly the same elements as COSO, they should have elements that encompass all of COSO's general themes. The auditor should therefore be able to apply the concepts and guidance in the proposed standard in a reasonable manner if management uses a framework other than COSO.

Regardless of how well any system of internal control over financial reporting is designed and operating, it cannot provide absolute assurance of achieving financial reporting objectives because of inherent limitations. These inherent limitations exist because internal control over financial reporting is a process that involves human diligence and compliance and, consequently, can be intentionally circumvented.

The Costs and Benefits of Internal Control

Effective internal control over financial reporting is essential for a company to effectively manage its affairs and to fulfill its obligation to its investors. A company's management and its owners – public investors – and others must be able to rely on the financial information reported by companies to make decisions.

Reliable financial reporting adds value and also can offset risks in a cost-beneficial manner. Evaluating a company's internal control over financial reporting is sometimes costly, but there also are many far-reaching benefits. Some of the benefits of a company developing, maintaining, and improving its system of internal control include identifying cost-ineffective procedures, reducing costs of processing accounting information, increasing productivity of the company's financial function, and simplifying financial control systems. It also may result in fewer financial statement restatements and less litigation. The primary benefit, however, is to provide the company, its management, its board and audit committee, and its owners and other stakeholders with a reasonable basis to rely on the company's financial reporting. The integrity of financial reporting represents the foundation upon which this country's public markets are built.

As companies develop processes to assist management in its internal control assessment under Section 404 and in its quarterly certification under Section 302, the annual assessment process should result in a continuous strengthening of internal controls while simultaneously reducing the future time and costs of compliance with these requirements. The Board anticipates that most companies will experience the highest cost of complying with Section 404 during the first year of implementation.

The Board is sensitive to the possible effects of the proposed standard on small and medium-sized companies. Internal control is not "one-size-fits-all," and the nature and extent of controls that are necessary depend, to a great extent, on the size and complexity of the company. Large, complex, multi-national companies, for example, are likely to need extensive and sophisticated internal control systems. In smaller companies, or in companies with less complex operations, the ethical behavior and core values of a senior management group that is directly involved in daily interactions with both internal and external parties might reduce the need for elaborate internal control systems. For a smaller, less complex company, the Board expects that the auditor will exercise reasonable professional judgment in determining the extent of the audit of internal control and perform only those tests that are necessary to ascertain the effectiveness of the company's internal control.

<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?

The Audit of Internal Control Over Financial Reporting

An audit of internal control over financial reporting is an extensive process involving several steps. It is integrated with the audit of the financial statements. Under the proposed auditing standard, these steps would include: planning the audit; evaluating the process management used to perform its assessment of internal control effectiveness; obtaining an understanding of the internal control; evaluating the effectiveness of both the design and operation of the internal control; and forming an opinion about whether internal control over financial reporting is effective.

The auditor's objective is to express an opinion about whether management's assessment, or conclusion, on the effectiveness of internal control over financial reporting is stated fairly, in all material respects. To support his or her opinion, the auditor must obtain evidence about whether internal control over financial reporting is effective. The auditor obtains this evidence in several ways, including evaluating and testing management's assessment process; evaluating and testing work on internal control performed by others, such as internal auditors; and testing the effectiveness of the controls himself or herself.

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.

Evaluating Management's Assessment

A natural starting place for the audit of a company's internal control over financial reporting is an evaluation of management's assessment. This evaluation provides the auditor with confidence that management has a basis for expressing its opinion on the effectiveness of internal control, provides information that will help the auditor understand the company's internal control, helps the auditor plan the work necessary to complete the audit, and provides some of the evidence the auditor will use to support his or her opinion.

The objective of an audit of internal control over financial reporting is to form an opinion "as to whether management's assessment of the effectiveness of the registrant's internal control over financial reporting is fairly stated in all material respects."[2/] Further, Section 103(a)(2)(A)(iii) of the Act requires the auditor's report to present an evaluation of whether the internal control structure provides reasonable assurance that transactions are recorded as necessary, among other requirements. Importantly, the auditor's conclusion will pertain directly to whether the auditor can agree with management that internal control is effective, not just to the adequacy of management's process for determining whether internal control is effective. An auditing process restricted to evaluating what management has done would not provide the auditor with a sufficiently high level of assurance that management's conclusion is

[2/] See SEC Regulation S-X 2-02(f), 17 C.F.R. 210.2-02(f).

correct. The auditor needs to evaluate management's assessment process to be satisfied that management has an appropriate basis for its conclusion. The auditor, however, also needs to test the effectiveness of internal control to be satisfied that management's conclusion is correct and, therefore, fairly stated. Indeed, as the Board heard at the internal control roundtable, investors expect the independent auditor to test whether the company's internal control over financial reporting is effective, and the proposed auditing standard would require the auditor to do so.

Nevertheless, the work that management performs in connection with its assessment can have a significant effect on the nature, timing, and extent of the work the independent auditor will need to perform. The proposed auditing standard would allow the auditor to use, to a reasonable degree, the work performed by others, including management. Thus, the more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be.

As a part of evaluating management's assessment, the auditor must evaluate the adequacy of management's documentation of the design of the internal controls and their assessment of internal control effectiveness. The proposed standard would provide the auditor with criteria to use in evaluating the adequacy of management's documentation. Inadequate documentation would be considered an internal control deficiency, the severity of which the auditor would evaluate just as he or she would be required to evaluate the severity of other internal control deficiencies.

<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?

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

8. Is it appropriate to state that inadequate documentation is an internal control deficiency, the severity of which the auditor should evaluate? Or should inadequate documentation automatically rise to the level of significant deficiency or material weakness in internal control?

Planning the Audit

Planning the audit of internal control over financial reporting allows the auditor to develop an overall strategy for the audit. Many factors enter into audit planning, and the proposed auditing standard includes among them the auditor's knowledge of the company, matters affecting the company's industry, matters relating to the company's business, and the extent of recent changes in the company's operations or internal control over financial reporting. Armed with a good understanding of these types of factors, the auditor is in a position to effectively design the nature, timing, and scope of the audit.

Obtaining an Understanding of Internal Control Over Financial Reporting

The auditor should understand how internal control over financial reporting is designed and operates to evaluate and test its effectiveness. The auditor obtains a substantial amount of this understanding when evaluating management's assessment process.

The auditor also should be satisfied, however, that the controls *actually* have been implemented and are operating as they were designed to operate. Thus, while inquiry of company personnel and a review of management's assessment provide the auditor with an understanding of how the system of internal control is designed and operates, other procedures are necessary for the auditor to confirm his or her understanding.

The proposed auditing standard would have the auditor confirm his or her understanding by performing procedures that include making inquiries of and observing the personnel who actually perform the controls; reviewing documents that are used in, and that result from, the application of the controls; and comparing supporting documents (for example, sales invoices, contracts, and bills of lading) to the accounting records. The most effective means of accomplishing this objective is for the auditor to perform "walkthroughs" of the company's significant processes. For this reason, and because of the importance of several other objectives that walkthroughs accomplish, the proposed auditing standard would require the auditor to perform walkthroughs in each audit of internal control over financial reporting.

In a walkthrough, the auditor traces all types of company transactions and events – both those that are routine and recurring and those that are unusual – from origination, through the company's accounting and information systems and financial report preparation processes, to their being reported in the company's financial statements. Walkthroughs provide the auditor with audit evidence that supports or refutes his or her understanding of the process flow of transactions, the design of controls, and whether controls are in operation. Walkthroughs also help the auditor to determine whether his or her understanding is complete and provide information necessary for the auditor to evaluate the effectiveness of the design of the internal control over financial reporting.

Because of the judgment that a walkthrough requires and the significance of the objectives that walkthroughs allow the auditor to achieve, the proposed auditing standard would require the auditor to perform the walkthroughs himself or herself. In other words, the proposed auditing standard would not allow the auditor to use the work performed by management or others to satisfy the requirement to perform walkthroughs.

As a part of obtaining an understanding of internal control, the auditor also determines which controls should be tested, either by the auditor, management or others. The proposed standard would require that the auditor obtain evidence about the operating effectiveness of internal control over financial reporting for all relevant assertions for all significant accounts or disclosures. This requirement relies heavily on two concepts: significant account and relevant assertion.

The auditing standards implicitly recognize that some accounts are more significant than others. The proposed standard provides additional direction on how to determine significant accounts for purposes of the audit of internal control over financial reporting. In short, the auditor begins by performing a quantitative evaluation of accounts at the financial-statement caption or note-disclosure level. Then the auditor expands the evaluation to include qualitative factors, such as differing risks, company organization structure, and other factors, which would likely result in additional accounts being identified as significant.

Financial statement amounts and disclosures embody what are known as financial statement assertions. Does the asset exist, or did the transaction occur? Has the company included all loans outstanding in its loans payable account? Have marketable investments been properly valued? Does the company have the rights to the accounts receivable, and are the loans payable the proper obligation of the company? Are the amounts in the financial statements appropriately presented, and is there adequate disclosure about them? This process will allow the auditor to identify the relevant financial statement assertions for which the company should have controls.

Identifying "relevant" assertions is a familiar process for experienced auditors. Because of the importance relevant assertions play in the required extent of testing, the proposed standard provides additional direction.

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?

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?

Testing and Evaluating the Effectiveness of the Design of Controls

To be effective, internal controls must be designed properly and all the controls necessary to provide reasonable assurance about the fairness of a company's financial statements should be in place and performed by appropriately qualified people who have the authority to implement them. At some point during the internal control audit, the auditor will need to make a determination as to whether the controls would be effective if they were operated as designed, and whether all the necessary controls are in place. This is known as *design effectiveness*.

The procedures the auditor performs to test and evaluate design effectiveness include inquiries of company personnel, observation of internal controls, walkthroughs, and a specific evaluation of whether the controls are likely to prevent or detect financial statement misstatements if they operate as designed. The proposed auditing standard would adopt these methods of testing and evaluating design effectiveness. The last step is especially important because it calls for the auditor to apply professional judgment and knowledge of and experience with internal control over financial reporting to his or her understanding of the company's controls.

Testing Operating Effectiveness

The proposed standard would require the auditor to obtain 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.

For this reason, in addition to being satisfied as to the effectiveness of the design of the internal controls, the auditor performs tests of controls to obtain evidence about the operating effectiveness of the controls. These tests include a mix of inquiries of appropriate company personnel, inspection of relevant documentation, such as sales orders and invoices, observation of the controls in operation, and reperformance of the application of the control.

The proposed standard directs required tests of controls to "relevant assertions" rather than to "significant controls." To comply with the requirements of the proposed standard, the auditor would apply tests to those controls that are important to fairly presenting each relevant assertion in the financial statements. It is neither necessary to test all controls nor is it necessary to test redundant controls (unless redundancy is itself a control objective, as in the case of certain computer controls). However, the emphasis is better placed on addressing relevant assertions (because those are the points where misstatements could occur) rather than significant controls. This emphasis encourages the auditor to identify and test controls that address the primary areas where misstatements could occur yet limits the auditor's work to only the necessary controls.

Expressing the extent of testing in this manner also resolves the issue of the extent of testing from year to year (the so-called "rotating tests of controls" issue). The proposed standard states that the auditor should vary testing from year to year, both to introduce unpredictability into the testing and to respond to changes at the company. However, each year's audit must stand on its own. Therefore, the auditor must obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year.

The Act requires management's assessment and the auditor's opinion to address whether internal control was effective as of the end of the company's most recent fiscal year, in other words, as of a point-in-time. Performing all of the testing on December 31 is neither practical nor appropriate, however. To form a basis to express an opinion about whether internal control was effective as of a point in time requires the auditor to obtain evidence that the internal control operated effectively over an appropriate period of time. The proposed auditing standard recognizes this and allows the auditor to obtain evidence about operating effectiveness at different times throughout the year, provided that the auditor updates those tests or obtains other evidence that the controls still operated effectively at the end of the company's fiscal year.

Also at the Board's roundtable, public company representatives and auditors indicated that providing examples of extent of testing decisions would be helpful. In response, paragraph B41 of Appendix B of the proposed standard includes several examples.

<u>Question regarding testing operating effectiveness</u>:

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?

Using the Work of Management and Others

The auditor also should consider other relevant and available information about internal control when evaluating internal control effectiveness. In this regard, the proposed standard would require the auditor to understand the results of procedures performed by management and others, for example, internal auditors and third parties working under the direction of management, on internal control over financial reporting. At a minimum, the auditor should consider the results of those tests in designing the audit approach and ultimately in forming an opinion on the effectiveness of internal control over financial reporting. To this end, the proposed standard would require the auditor to review all reports issued during the year by internal audit (or similar functions, such as loan review in a financial institution) that address internal controls over financial reporting and evaluate any internal control deficiencies identified in those reports.

Additionally, the auditor may use the results of testing by others to alter the nature, timing, and extent of his or her tests of controls. At the Board's roundtable, public company representatives indicated their concern that at some point, the Board's standard could require an excessive amount of retesting by the auditor in order to use the work of others, especially internal auditors. Public company representatives were particularly sensitive to this issue because of its direct bearing on their total cost to comply with Section 404. On the other hand, the federal bank regulator representative indicated that experience with the Federal Deposit Insurance Corporation Improvement Act of 1991, which requires internal control reporting similar to Section 404 of the Act, revealed instances where the auditor used the work of internal auditors to an inappropriately high degree, where the auditor himself or herself did not perform sufficient work to provide a reasonable basis for his or her opinion.

The proposed standard describes an evaluation process, focusing on the competence and objectivity of the persons who performed the work, that the auditor should use in determining the extent to which he or she may use the work of others. The proposed standard also describes two principles that limit the auditor's use of the work of others. First, the proposed standard defines three categories of controls and the extent to which the auditor may use the work of others for each of these categories: (1) controls for which the auditor should not rely on the work of others, such as controls in the control environment and controls specifically intended to prevent or detect fraud that is reasonably likely to have a material effect on the company's financial statements, (2) controls for which the auditor may rely on the work of others but his or her reliance on the work of others should be limited, such as controls over nonroutine transactions that are considered high risk because they involve judgments and estimates, and (3) controls for which the auditor's reliance on the work of others is not specifically limited, such as controls over routine processing of significant accounts. Second, the proposed standard requires that, on an overall basis, the auditor's own work must provide the principal evidence for the audit opinion.

These two principles interact to provide the auditor with flexibility in using the work of others and also prevent inappropriate over-reliance on the work of others. Although the proposed standard requires that the auditor reperform some of the tests performed by others in order to use their work, it does not set any specific requirement on the extent of the reperformance. For example, the standard does not require that the auditor reperform tests of controls over all significant accounts for which the auditor uses the work of others. Rather, the proposed standard relies on the auditor's judgment and the interaction of the two principles discussed above to determine the appropriate extent of reperformance.

<u>Questions regarding using the work of management and others</u>:

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

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

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?

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)?

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?

Evaluating the Results

Both management and the auditor may identify deficiencies in internal control over financial reporting. An *internal control deficiency* exists when the design or operation of a control does not allow the company's management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

The proposed auditing standard would require the auditor to evaluate the severity of all identified internal control deficiencies because such deficiencies can have an effect on the auditor's overall conclusion about whether internal control is effective. The auditor also has a responsibility to make sure that certain parties, such as the audit committee, are aware of internal control deficiencies that rise to a certain level of severity.

Under the proposed auditing standard, an internal control deficiency (or a combination of internal control deficiencies) should be classified as a *significant deficiency* if, by itself or in combination with other internal control deficiencies, it results in more than a remote likelihood of a misstatement of the company's annual or interim financial statements that is more than inconsequential in amount will not be prevented or detected. A significant deficiency should be classified as a *material weakness* if, by itself or in combination with other internal control deficiencies, it results in more than a remote likelihood that a material misstatement in the company's annual or interim financial statements will not be prevented or detected.

At the Board's roundtable, issuers, investors and auditors all suggested that while the existing definitions of internal control deficiencies are familiar and not fundamentally flawed, additional guidance that provides additional specificity would be very helpful. However, the participants acknowledged that articulating such guidance is very difficult, particularly because the process of evaluating deficiencies and whether they constitute significant deficiencies or material weaknesses will necessarily always involve judgment. The Roundtable participants suggested that the Board provide additional guidance in the form of examples.

The proposed auditing standard's definitions of significant deficiency and material weakness focus on likelihood and magnitude as the framework for evaluating deficiencies. The Board anticipates that this framework will bring increased consistency to these evaluations yet preserve an appropriate degree of judgment. Additionally, the proposed standard includes examples in Appendix D of how these definitions would be applied in several different scenarios.

The proposed auditing standard requires the auditor to communicate in writing to the company's audit committee all significant deficiencies and material weaknesses of which the auditor is aware. The auditor also is required to communicate to the company's management, in writing, all internal control deficiencies of which he or she is aware and to notify the audit committee that such communication has been made.

The proposed standard identifies a number of circumstances that, because of their likely significant negative effect on internal control over financial reporting, are significant deficiencies as well as *strong indicators* that a material weakness exists, including –

- *Ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee.* Effective oversight by the company's board of directors, including its audit committee, is essential to the company's achievement of its objectives and is an integral part of a company's monitoring of internal control. In addition to requiring the audit committee to oversee the company's external financial reporting and internal control over financial reporting, the Act makes the audit committee directly responsible for the appointment, compensation, and oversight of the work of the auditor. Thus, an ineffective audit committee can have detrimental effects on the company and its internal control over financial reporting, as well as on the independent audit. The proposed auditing standard requires the auditor to evaluate factors related to the effectiveness of the audit committee's oversight of the external financial reporting process and internal control over financial reporting, including whether audit committee members act independently from management.

- *Material misstatement in the financial statements not initially identified by the company's internal controls.* The audit of internal control over financial reporting and the audit of the company's financial statements are an integrated activity and are required by the Act to be a single engagement. The results of the work performed in a financial statement audit provide evidence to support the auditor's conclusions on the effectiveness of internal control, and vice-versa. Therefore, if the auditor discovers a material misstatement in the financial statements as a part of the audit of the financial statements, the auditor should consider whether internal control over financial reporting is effective. That the company's internal controls did not first detect the misstatement is a strong indicator that the company's internal control over financial reporting is not effective.

- *Significant deficiencies that have been communicated to management and the audit committee, but that remain uncorrected after some reasonable period of time.* Significant deficiencies in internal control that are not also determined to be material weaknesses, as defined in the proposed auditing standard, are not so severe as to require the auditor to conclude that internal control is ineffective. However, these deficiencies are, nonetheless, significant, and the auditor should expect the company to correct them. If management fails to correct significant deficiencies within a reasonable period of time, that situation reflects poorly on tone-at-the-top as well as the control environment. Additionally, the significance of the deficiency can change over time (for example, increases in sales volume or added complexity in sales transaction structures would increase the severity of a significant deficiency affecting sales).

Questions regarding evaluating results:

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?

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?

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

20. Is it appropriate to require the auditor to communicate all internal control deficiencies (not just material weaknesses and significant deficiencies) to management in writing?

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

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?

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

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?

Forming an Opinion and Reporting

If the auditor has identified no material weaknesses in internal control after having performed all of the procedures that the auditor considers necessary in the circumstances, then the proposed standard would permit the auditor to express an unqualified opinion that management's assessment of the effectiveness of internal control over financial reporting is fairly stated in all material respects. In the event that the auditor could not perform all of the procedures that the auditor considers necessary in the circumstances, then the proposed standard would permit the auditor to either qualify or disclaim an opinion. If an overall opinion cannot be expressed, the proposed auditing standard would require the auditor to explain why.[3/]

No Disclosure of Significant Deficiencies

The auditor's report must follow the same disclosure model as management's assessment. The SEC's final rules implementing Section 404 only require management's assessment to disclose material weaknesses, not significant deficiencies. Therefore, because management's assessment will disclose only material weaknesses, the auditor's report should disclose only material weaknesses.[4/]

Material Weaknesses Result in Adverse Opinion

The existing attestation standard provides that when the auditor has identified a material weakness in internal control, depending on the significance of the material weakness and its effect on the achievement of the objectives of the control criteria, the auditor may qualify his or her opinion ("except for the effect of the material weakness,

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[3/] See also SEC Regulation S-X 2-02(f), 17 C.F. R. § 212.2-02(f) ("The attestation report on management's assessment of internal control over financial reporting shall be dated, signed manually, identify the period covered by the report and clearly state the opinion of the accountant as to whether management's assessment of the effectiveness of the registrant's internal control over financial reporting is fairly stated in all material respects, or must include an opinion to the effect that an overall opinion cannot be expressed. If an overall opinion cannot be expressed, explain why.").

[4/] It should be noted, however, that the final rules indicated that an aggregation of significant deficiencies may constitute a material weakness in a company's internal control over financial reporting, in which case disclosure would be required. See Final Rule: Management's Reports in Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities and Exchange Commission Release No. 33-8238, (June 5, 2003) [68 FR 36636].

internal control was effective") or may express an adverse opinion ("internal control over financial reporting was not effective").

The SEC's final rules implementing Section 404 state that "Management is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting." In other words, in such a case, management must conclude that internal control is not effective (i.e., a qualified or "except for" conclusion is not acceptable).

Similar to the reporting of significant deficiencies, the reporting model for the auditor must follow the required reporting model for management. Therefore, because management is required to express an "adverse" conclusion in the event a material weakness exists, the auditor's opinion must also be adverse; the proposed standard does not permit a qualified audit opinion in the event of a material weakness.

Questions regarding forming an opinion and reporting:

25. Is it appropriate that the existence of a material weakness would require the auditor to express an adverse conclusion about the effectiveness of the company's internal control over financial reporting, consistent with the required reporting model for management?

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

27. Do you agree with the position that when the auditor issues a non-standard opinion, such as an adverse opinion, that the auditor's opinion should speak directly to the effectiveness of the internal control over financial reporting rather than to whether management's assessment is fairly stated?

Fraud Considerations in an Audit of Internal Control Over Financial Reporting

Strong internal controls provide better opportunities to detect and deter fraud. For example, many frauds resulting in financial statement restatement relied upon the ability of management to exploit weaknesses in internal control. To the extent that the internal control reporting required by Section 404 can help restore investor confidence by improving the effectiveness of internal controls (and reducing the incidence of fraud), the auditing standard on performing the audit of internal control over financial reporting should emphasize controls that prevent or detect errors as well as fraud. For this reason, the proposed standard specifically addresses and emphasizes the importance of controls over possible fraud and requires the auditor to test controls specifically intended to prevent or detect fraud that is reasonably likely to result in material misstatement of the financial statements.

Auditor Independence

The Act, and the SEC rules implementing Section 404 of the Act, require the auditor to be independent to perform an audit of internal control over financial reporting. Under the SEC's Rule 2-01 on auditor independence, an auditor impairs his or her independence if the auditor audits his or her own work, including any work on designing or implementing an audit client's internal control system. The proposed standard explicitly prohibits the auditor from accepting an engagement to provide an internal control-related non-audit service to an audit client that has not been specifically pre-approved by the audit committee. In other words, the audit committee would not be able to pre-approve internal control-related non-audit services as a category. Rather, each specific engagement would be required to be specifically pre-approved.

While the Board has not proposed to provide specific guidance on permissible internal control-related non-audit services in the proposed standard on the audit of internal control, the Board intends to conduct an in-depth evaluation of independence requirements in the future. The Board may, as a result of its evaluation, amend the independence information included in the proposed auditing standard.

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?

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

Auditor's Responsibilities With Regard to Management's Certifications

The proposed standard also outlines the auditor's work related to management's quarterly and annual certifications required by Section 302 of the Act.

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A company's principal executive and financial officers are responsible for internal control over financial reporting. Section 302 of the Act emphasizes this responsibility by requiring these parties to certify, quarterly and annually, their responsibility, among others, for establishing and maintaining internal control over financial reporting and for disclosing changes in the company's internal control over financial reporting that occurred during the most recent quarter (or the fourth quarter, for the annual certification) that have materially affected, or are likely to affect materially, the company's internal control over financial reporting.

The Board believes that the auditor's responsibility for management's disclosure of a material weakness corrected by the end of one of the first three quarters should be similar to the auditor's responsibility regarding material misstatements of interim financial statements. Under AU sec. 722, *Interim Financial Information*,[5/] the auditor performs limited procedures on the interim financial information which are substantially less than an audit; however, if the auditor became aware that the financial statements are materially misstated, the auditor would be required to communicate the matter to management. If management fails to respond appropriately, the auditor would be required to communicate the matter to the audit committee. If the audit committee did not respond appropriately, the auditor would be required to evaluate whether or not to resign from the engagement. The auditor also has responsibilities under AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934. If the auditor became aware that a material weakness in internal control had been identified and corrected yet management had not appropriately disclosed the correction in its report as indicated in the quarterly certification, that situation would be closely analogous to the auditor's knowledge of a material financial statement misstatement. Therefore, the responsibilities should run a similar path.

The auditor has a different level of responsibility as it relates to changes in internal control made in the fourth quarter. While the auditor is not required to issue a

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[5/] The Board adopted the generally accepted auditing standards, as described in the American Institute of Certified Public Accountants' ("AICPA") Auditing Standards Board's ("ASB") Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards*, as in existence on April 16, 2003, on an initial, transitional basis. The Statements on Auditing Standards promulgated by the ASB have been codified into the AICPA *Professional Standards*, Volume 1, as AU sections 100 through 900. References in this Release to AU sections refer to those generally accepted auditing standards, as adopted on an interim basis in PCAOB Rule 3200T.

report on his or her quarterly review procedures, the auditor is required to report on management's annual assessment based on his or her audit of internal control. If, as a result of the auditor's audit procedures, the auditor becomes aware that management's annual report fails to appropriately disclose a material weakness that was corrected during the fourth quarter, the auditor has the responsibility to modify his or her audit report on internal control. Assume, for example, that management identified and corrected a material weakness during the fourth quarter and that the material weakness was corrected in time for both management and the auditor to have a sufficient period of time to test the operating effectiveness of the correction. Management makes the conclusion in its report on its assessment of internal control over financial reporting that internal control over financial reporting is effective; the auditor's opinion is unqualified, stating that management's assessment is stated fairly. However, if the company's annual report fails to also disclose the material weakness that was identified and corrected in the fourth quarter, and the auditor concludes that the disclosure is material information, the auditor would have to include an explanatory paragraph in his or her report describing the material weakness that was identified and corrected in the fourth quarter and note it was omitted from the company's annual report.

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?

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

Effective Date of the Proposed Standard

Companies considered accelerated filers (seasoned U.S. companies with public float exceeding $75 million) are required to comply with the internal control reporting and disclosure requirements of Section 404 of the Act for fiscal years ending on or after June 15, 2004. Accordingly, auditors engaged to audit the financial statements of such companies for fiscal years ending on or after June 15, 2004, also are required to audit and report on the company's internal control over financial reporting as of the end of such fiscal year. Other companies (including smaller companies, foreign private issuers and companies with only registered debt securities) have until fiscal years ending on or after April 15, 2005, to comply with these internal control reporting and disclosure requirements and the requirement for audit reporting on internal control is similarly delayed. The proposed standard would be effective at the same time as these requirements. Early implementation of the proposed standard would be permitted.

Opportunity for Public Comment

The Board will seek comment on the proposed standard for a 45-day period. Interested persons are encouraged to submit their views to the Board. Written comments should be sent to Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments may also be submitted by e-mail to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 008 in the subject or reference line and should be received by the Board no later than 5:00 PM (EST) on November 21, 2003.

The Board will carefully consider all comments received. Following the close of the comment period, the Board will determine whether to adopt a final standard, with or without amendments. Any final standard adopted will be submitted to the Securities and Exchange Commission for approval. Pursuant to Section 107 of the Act, proposed rules of the Board do not take effect unless approved by the Commission. Standards are deemed to be rules under the Act.

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On the 7th day of October, in the year 2003, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour
Acting Secretary

October 7, 2003

APPENDIX –

Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements

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Appendix – Proposed Auditing Standard

AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Proposed Auditing Standard –

AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS

PCAOB
Public Company Accounting Oversight Board

STATEMENT OF AUTHORITY

The Public Company Accounting Oversight Board (the "Board") is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002 (the "Act") to oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.

The Board has adopted Rule 3100 to require all registered public accounting firms to adhere to the Board's auditing and related professional practice standards (including interim professional standards) in the audits of public companies. Any registered public accounting firm that fails to adhere to the Board's standards is subject to disciplinary proceedings in accordance with Section 105 of the Act and the Board's rules.

Reference in the Board's standards to "the auditor" means a registered public accounting firm or an associated person of such a firm as defined in the Act and the Board's rules, unless specifically stated otherwise.

Reference in the Board's standards to the AICPA Professional Standards refers to those professional standards as they existed on April 16, 2003, the date the Board adopted them as interim standards.

The Board has proposed Rule 3101 regarding the use of certain terms in the Board's standards.[*] The Board's standards use the words "must," "shall," or "is required" to indicate unconditional obligations. The auditor's performance of these obligations is necessary to the accomplishment of the audit. The standards use the word "should" to indicate obligations that are presumptively mandatory. The auditor must comply with the requirements of this nature specified in the Board's standards unless the auditor can demonstrate, by verifiable objective and documented evidence, that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard and serve adequately to protect the interests of investors and further the preparation of informative, fair, and independent audit reports. The Board uses the words "may," "might," "could," or other terms and phrases to describe actions and procedures that the auditor has a professional obligation to consider. Matters described in this fashion require the auditor's attention and understanding; how and whether they are implemented in the audit will depend on the exercise of professional judgment in the circumstances. Additionally, appendices to the Board's standards are an integral part of the standard and carry the same authoritative weight as the body of the standard.

This Statement of Authority is an integral part of the Board's auditing and related professional practice standards.

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[*] See PCAOB Release No. 2003-019, *Proposed Rule Regarding Certain Terms Used in Auditing and Related Professional Practice Standards*.

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Appendix D – Examples of Material Weaknesses and Significant Deficiencies

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1. This standard establishes requirements that apply when an auditor is engaged to audit both a company's financial statements and management's assessment of the effectiveness of internal control over financial reporting.[1]

2. A company subject to the reporting requirements of the Securities Exchange Act of 1934 is required to include in its annual report a report of management on the company's internal control over financial reporting**.** Registered investment companies, issuers of asset-backed securities, and nonpublic companies are not subject to the reporting requirements mandated by Section 404 of the Sarbanes-Oxley Act (the Act) of 2002 (PL 107-204). The report of management is required to contain management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including a statement as to whether the company's internal control over financial reporting is effective. The auditor that audits the company's financial statements included in the annual report is required to attest to and report on management's assessment. The company is required to file the auditor's attestation report as part of the annual report.

3. This standard is the standard on attestation engagements referred to in Section 404(b) of the Act.[2] Throughout this standard, the auditor's attestation of management's assessment of the effectiveness of internal control over financial reporting required by

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[1] This standard supersedes Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting" of *Statement on Standards for Attestation Engagements No. 10, Attestation Standards: Revision and Recodification* (AICPA*, Professional Standards,* Vol. 1, AT sec. 501), as it relates to performing an audit (referred to in AT sec. 501 as an "examination") of the design and operating effectiveness of internal control over financial reporting. This standard also supersedes *Statement on Auditing Standards No. 60*, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards,* Vol. 1, AU sec. 325). This standard requires that, for public companies, the auditor cannot audit internal control over financial reporting without also auditing the financial statements. However, the auditor may audit the financial statements without also auditing internal control over financial reporting. When an auditor is engaged to audit only the financial statements of a public company, this standard does not apply. However, in that situation, the auditor should follow this standard as it relates to the definition of a deficiency in internal control over financial reporting, a significant deficiency, and a material weakness, as well as the required communications of these matters described herein.

[2] This standard is also the standard referred to in Section 103(a)(2)(A)(iii).

Section 404(b) of the Act is referred to as the *audit of internal control over financial reporting*.[3]

Auditor's Objective in an Audit of Internal Control Over Financial Reporting

4. The auditor's objective in an audit of internal control over financial reporting is to express an opinion on management's assessment of the effectiveness of the company's internal control over financial reporting. To form a basis for expressing such an opinion, the auditor must plan and perform the audit to obtain reasonable assurance about whether the company maintained, in all material respects, effective internal control over financial reporting as of the date specified in management's assessment.

5. To obtain reasonable assurance, the auditor evaluates the assessment performed by management and obtains and evaluates evidence about whether the internal control over financial reporting is designed and operated effectively. The auditor obtains this evidence from a number of sources, including using the work performed by management in making its assessment, internal auditors and others under the direction of management, and performing auditing procedures himself or herself.

Definitions Related to Internal Control Over Financial Reporting

6. For purposes of management's assessment and the audit of internal control over financial reporting in this standard, *internal control over financial reporting* is defined as follows:[4]

> A process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar

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[3] The two terms "audit of internal control over financial reporting" and "attestation of management's assessment of the effectiveness of internal control over financial reporting" refer to the same professional service. The first refers to the process, and the second refers to the result of that process.

[4] This definition is the same one used by the SEC in its rules requiring management to report on internal control over financial reporting, except the word "registrant" has been changed to "company" to conform to the wording in this standard. (See Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities and Exchange Commission Release No. 33-8238 (June 5, 2003) [68 FR 36636].)

functions, and effected by the company's board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

(1) Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;

(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

7. An *internal control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

- A deficiency in *design* exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that even if the control operates as designed, the control objective is not always met.

- A deficiency in *operation* exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively.

8. A *significant deficiency* is 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. A significant deficiency could be a single deficiency, or a combination of deficiencies, that results in more than a remote likelihood[5] that a misstatement of the annual or interim financial statements that is more than inconsequential in amount will not be prevented or detected.

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[5] The term "remote likelihood" as used in the definition of *significant deficiency* and *material weakness* has the same meaning as the term "remote" as used

9. A *material weakness* is 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.

10. Internal controls over financial reporting may be *preventive controls* or *detective controls*.

- Preventive controls have the objective of preventing a misstatement from occurring in the first place.
- Detective controls have the objective of detecting a misstatement that has already occurred.

11. Even well-designed internal controls might not prevent a misstatement from occurring. However, this possibility is countered by detective controls. Therefore, effective internal control over financial reporting often includes a combination of preventive and detective controls to achieve a specific control objective. The auditor's procedures as part of either the audit of internal control over financial reporting or the audit of the financial statements are not part of a company's internal controls over financial reporting.

Framework Used by Management to Conduct Its Assessment

12. Management is required to base its assessment of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework established by a body of experts that followed due-process procedures,

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in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies* (FAS No. 5). Paragraph 3 of FAS No. 5 states:

> When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms *probable, reasonably possible*, and *remote* to identify three areas within that range, as follows:
>
> a. *Probable*. The future event or events are likely to occur.
> b. *Reasonably possible*. The chance of the future event or events occurring is more than remote but less than likely.
> c. *Remote*. The chance of the future events or events occurring is slight.

including the broad distribution of the framework for public comment. In addition to being available to users of management's reports, a framework is suitable only when it:

- Is free from bias;

- Permits reasonably consistent qualitative and quantitative measurements of a company's internal control over financial reporting;

- Is sufficiently complete so that those relevant factors that would alter a conclusion about the effectiveness of a company's internal controls over financial reporting are not omitted; and

- Is relevant to an evaluation of internal control over financial reporting.

Committee of Sponsoring Organizations Framework

13. In the United States, the Committee of Sponsoring Organizations (COSO) of the Treadway Commission has published *Internal Control – Integrated Framework*. Known as the COSO report, it provides a suitable and available framework for purposes of management's assessment. For that reason, the performance and reporting directions in this standard are based on the COSO framework. Other suitable frameworks have been published in other countries and may be developed in the future. Such other suitable frameworks may be used in an audit of internal control over financial reporting. Although different frameworks may not contain exactly the same elements as COSO, they should have elements that encompass, in general, all the themes in COSO. The auditor should therefore be able to apply the concepts and guidance in this standard in a reasonable manner.

14. The COSO perspective on internal control over financial reporting does not ordinarily encompass elements related to the effectiveness and efficiency of operations or compliance with laws and regulations. However, operations and 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. Additionally, not all controls relevant to financial reporting are accounting controls. The auditor should identify all controls that could materially affect financial reporting, including controls that focus primarily on the effectiveness and efficiency of operations or compliance with laws and regulations and which also have a material effect on the reliability of financial reporting. More information about the COSO framework is included in AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit.*[6]

[6] The Board adopted the generally accepted auditing standards, as described in the AICPA Auditing Standards Board's (ASB) Statement on Auditing

Appendix E discusses special internal control over financial reporting considerations for small and medium-sized companies.

Inherent Limitations in Internal Control Over Financial Reporting

15. Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

Reasonable Assurance

16. Management's assessment of the effectiveness of internal control over financial reporting is expressed at the level of *reasonable assurance*. The concept of reasonable assurance is built into the definition of internal control over financial reporting and also is integral to the auditor's opinion.[7] Reasonable assurance includes the understanding that there is a relatively low risk that material misstatements will not be prevented or detected on a timely basis. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance.

17. Just as there are inherent limitations on the assurance that can be provided by effective internal control over financial reporting, as discussed in paragraph 15, there are limitations on the amount of assurance the auditor can obtain as a result of performing his or her audit of internal control over financial reporting. Limitations arise

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Standards No. 95, *Generally Accepted Auditing Standards,* as in existence on April 16, 2003, on an initial, transitional basis. The Statements on Auditing Standards promulgated by the ASB have been codified into the AICPA *Professional Standards*, Volume 1, as AU sections 100 through 900. References in this standard to AU sections refer to those generally accepted auditing standards, as adopted on an interim basis in PCAOB Rule 3200T.

[7] See Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities and Exchange Commission Release No. 33-8238 (June 5, 2003) [68 FR 36636] for further discussion of reasonable assurance.

because an audit is conducted on a test basis and requires the exercise of professional judgment. Nevertheless, the audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control over financial reporting, and performing such other procedures as the auditor considers necessary to obtain reasonable assurance about whether internal control over financial reporting is effective.

18. Users of the reports from management and the auditor are entitled to receive the same level of assurance from both management and the auditor. This means that users should expect reasonable assurance that internal control over financial reporting is effective. There is no difference in the level of work or assurance given by the auditor when expressing an opinion on management's assessment of effectiveness or when expressing an opinion directly on the effectiveness of internal control over financial reporting. In either case, the auditor must obtain sufficient evidence in order to provide a reasonable basis for his or her opinion and the use and evaluation of management's assessment is inherent in expressing either opinion. The auditor provides the same level of assurance, though not the same assurance, as management. However, the auditor's assurance does not relieve management of its responsibility for assuring users of its financial reports about the effectiveness of internal control over financial reporting.

Management's Responsibilities in an Audit of Internal Control Over Financial Reporting

19. For the auditor to satisfactorily complete an audit of internal control over financial reporting, management must do the following:[8]

a. Accept responsibility for the effectiveness of the company's internal control over financial reporting,

b. Evaluate the effectiveness of the company's internal control over financial reporting using suitable control criteria,

c. Support its evaluation with sufficient evidence, including documentation, and

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[8] Management is required to fulfill these responsibilities. See Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities and Exchange Commission Release No. 33-8238 (June 5, 2003) [68 FR 36636].

d. Present a written assessment about the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year.

20. If the auditor concludes that management has not fulfilled the responsibilities enumerated in the preceding paragraph, the auditor should communicate, in writing, to management and the audit committee that the audit of internal control over financial reporting cannot be satisfactorily completed and that he or she is required to disclaim an opinion. Paragraphs 41 through 47 provide information for the auditor on understanding management's process for evaluating and reporting on internal control over financial reporting.

Materiality Considerations in an Audit of Internal Control Over Financial Reporting

21. The auditor should apply the concept of materiality in an audit of internal control over financial reporting at both the financial-statements level and at the individual account-balance level. The auditor uses materiality at the financial-statements level in deciding whether a significant deficiency, or combination of significant deficiencies, in controls is a material weakness. Materiality at the individual account-balance level is relevant to deciding whether a deficiency represents a significant deficiency; accordingly, it is lower than materiality at the financial-statements level.

22. The same conceptual definition of materiality that applies to financial reporting applies to information on internal control over financial reporting, including the relevance of both quantitative and qualitative considerations.[9]

- The quantitative considerations are essentially the same as in an audit of financial statements, and relate to whether misstatements that would not be prevented or detected by internal control over financial reporting, individually or collectively, have a quantitatively material effect on the financial statements.

- The qualitative considerations apply to evaluating materiality with respect to the financial statements and to additional factors that relate to the perceived needs of reasonable persons who will rely on the information.

23. The auditor should be aware that persons who rely on the information concerning internal control over financial reporting include investors, creditors, the board of directors and audit committee, and regulators in specialized industries, such as banking

[9] AU sec. 312, *Audit Risk and Materiality in Conducting an Audit,* provides additional explanation of materiality.

or insurance. Information on internal control over financial reporting is intended to provide an early warning to those inside and outside the company who are in a position to insist on improvements in internal control over financial reporting, such as the audit committee and regulators in specialized industries. The auditor should also be aware that external users are also interested in information on internal control over financial reporting because it enhances the quality of financial reporting and increases their confidence in financial information, particularly financial information issued between annual reports, such as quarterly information.

Fraud Considerations in an Audit of Internal Control Over Financial Reporting

24. The auditor should evaluate all controls specifically intended to address the risks of fraud that are reasonably likely to have a material effect on the company's financial statements, which may be a part of any of the five components of internal control over financial reporting, as discussed in paragraph 50. However, the auditor should place a special emphasis on the evaluation of such controls in the control environment. Controls related to the prevention, identification, and detection of fraud in the control environment often have a pervasive effect on the risk of fraud. Such controls include, but are not limited to, the:

- Controls restraining the inappropriate use of company assets,
- Company's risk assessment processes,
- Code of ethics/conduct provisions, especially those related to conflicts of interest, related party transactions, illegal acts, and the monitoring of the code by management and the audit committee or board,
- Adequacy of the internal audit activity and whether it reports functionally to the audit committee, and
- Adequacy of the company's procedures for handling complaints and for accepting confidential submissions of concerns about questionable accounting or auditing matters.

25. Part of management's responsibility when designing a company's internal control over financial reporting is to design and implement programs and controls to prevent, deter, and detect fraud. Management, along with those who have responsibility for oversight of the financial reporting process (such as the audit committee), should set the proper tone; create and maintain a culture of honesty and high ethical standards; and establish appropriate controls to prevent, deter, and detect fraud. When management

and those responsible for the oversight of the financial reporting process fulfill those responsibilities, the opportunities to commit fraud can be reduced significantly.

26. In an audit of internal control over financial reporting, the auditor's evaluation of controls is interrelated with the auditor's evaluation of controls in a financial statement audit, as required by AU sec. 316, *Consideration of Fraud in a Financial Statement Audit.* Often, controls identified and evaluated by the auditor during the audit of internal control over financial reporting also address or mitigate fraud risks, which the auditor is required to consider in a financial statement audit. If an auditor identifies deficiencies in controls related to the prevention, identification, and detection of fraud during the audit of internal control over financial reporting, the auditor should alter the nature, timing and extent of procedures to be performed during the financial statement audit to be responsive to such deficiencies, as provided in AU sec. 316.

Performing an Audit of Internal Control Over Financial Reporting

27. In an audit of internal control over financial reporting, the auditor must 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. Because of the potential significance of the information obtained during the audit of the financial statements to the auditor's conclusions about the effectiveness of internal control over financial reporting, the auditor cannot audit internal control over financial reporting without also auditing the financial statements.[10]

28. The auditor must adhere to the general and applicable fieldwork and reporting standards in performing an audit of a company's internal control over financial reporting. This involves the following:

a. Planning the engagement,

b. Evaluating management's assessment process,

c. Obtaining an understanding of internal control over financial reporting,

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[10] However, the auditor may audit the financial statements without also auditing internal control over financial reporting, as might be necessary, for example, in the case of certain initial public offerings by a company. See the discussion beginning at paragraph 131 for more information about the importance of auditing both internal control over financial reporting as well as the financial statements when the auditor is engaged to audit internal control over financial reporting.

d. Testing and evaluating design effectiveness of internal control over financial reporting,

e. Testing and evaluating operating effectiveness of internal control over financial reporting, and

f. Forming an opinion on the effectiveness of internal control over financial reporting.

29. Even though some requirements of this standard are set forth in a manner that suggests a sequential process, auditing internal control over financial reporting involves a process of gathering, updating, and analyzing information. Accordingly, the auditor may perform some of the procedures and evaluations described in this section on "Performing an Audit of Internal Control Over Financial Reporting" concurrently.

General and Applicable Fieldwork and Reporting Standards

30. The general standards (see AU sec. 150, *Generally Accepted Auditing Standards*) are applicable to an audit of internal control over financial reporting. These standards require technical training and proficiency as an auditor, independence in fact and appearance, and the exercise of due professional care, including professional skepticism.

31. *Technical Training and Proficiency.* To perform an audit of internal control over financial reporting, the auditor should have competence in the subject matter of internal control over financial reporting.

32. *Independence.* The applicable basic principles of independence are that, to remain independent, the auditor must not function in the role of management and must not audit his or her own work. If the auditor were to design or implement controls, that situation would place the auditor in a management role and result in auditing the auditor's own work. This does not necessarily preclude the auditor from making substantive recommendations as to how management may improve the design or operation of the company's internal controls.

33. For any internal control services the auditor provides, management must be actively involved and cannot delegate responsibility for these matters to the auditor. Management's involvement must be substantive and extensive. Management's acceptance of responsibility for documentation and testing performed by the auditor is not enough to satisfy the independence requirements. Additionally, the auditor must not accept an engagement to provide internal control-related services to an issuer audit client that has not been specifically pre-approved by the audit committee.

34. Maintaining independence, in fact and appearance, requires more than ordinary attention in an audit of internal control over financial reporting due to its complexity. Unless the auditor and the audit committee are diligent in evaluating the nature and extent of services provided, the services might violate basic principles of independence and cause an impairment of independence in fact or appearance.

35. The independent auditor and the audit committee have significant and distinct responsibilities for evaluating whether the auditor's services impair independence in fact or appearance. The test for independence in fact is whether the activities would impede the ability of anyone on the engagement team or in a position to influence the engagement team from exercising objective judgment in the audits of the financial statements or internal control over financial reporting. The test for independence in appearance is whether a reasonable investor, knowing all relevant facts and circumstances, would perceive an auditor as having interests which could jeopardize the exercise of objective and impartial judgments on all issues brought to the auditor's attention.

36. *Due Professional Care.* The auditor must exercise due professional care in an audit of internal control over financial reporting. One important tenet of due professional care is exercising professional skepticism. In an audit of internal control over financial reporting, exercising professional skepticism involves essentially the same considerations as in an audit of financial statements. It includes a critical assessment of the work that management has performed in evaluating and testing controls. Inquiry of management and employees is the beginning point for obtaining an understanding of internal control over financial reporting, but inquiry alone is not adequate for reaching a conclusion on any aspect of internal control over financial reporting effectiveness.

37. *Fieldwork and Reporting Standards.* This standard establishes the fieldwork and reporting standards applicable to an audit of internal control over financial reporting.

38. The concept of materiality, as discussed in paragraphs 21 through 23, underlies the application of the general and fieldwork standards.

Planning the Engagement

39. The audit of internal control over financial reporting should be properly planned and assistants, if any, are to be properly supervised. When planning the audit of internal control over financial reporting, the auditor should evaluate how the following matters will affect the auditor's procedures:

- Knowledge of the company's internal control over financial reporting obtained during other engagements.

- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes.

- Matters relating to the company's business, including its organization, operating characteristics, capital structure, and distribution methods.

- The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting.

- Management's process for assessing the effectiveness of the company's internal control over financial reporting based upon control criteria.

- Preliminary judgments about materiality, risk, and other factors relating to the determination of material weaknesses.

- Internal control deficiencies previously communicated to the audit committee or management.

- Legal or regulatory matters of which the company is aware.

- The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting.

- Preliminary judgments about the effectiveness of internal control over financial reporting.

- The number of significant business locations or units, including management's documentation and monitoring of controls over such locations or business units. (Appendix B, paragraphs B1 through B16, discusses factors the auditor should evaluate to determine the locations at which to perform auditing procedures.)

40. The auditor could also evaluate additional relevant factors when planning the audit of internal control over financial reporting.

Evaluating Management's Assessment Process

41. The auditor must obtain an understanding of, and evaluate, management's process for assessing the effectiveness of the company's internal control over financial reporting. When obtaining the understanding, the auditor should determine whether management has addressed the following elements:

- Determining which controls should be tested, including controls over relevant assertions related to all significant accounts and disclosures in the financial statements. Generally, such controls include:

  – Controls over initiating, recording, processing, and reporting significant accounts and disclosures and related assertions embodied in the financial statements.

  – Controls over the selection and application of accounting policies that are in conformity with generally accepted accounting principles.

  – Antifraud programs and controls.

  – Controls, including information technology general controls, on which other controls are dependent.

  – Controls over significant nonroutine and nonsystematic transactions, such as accounts involving judgments and estimates.

  – Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; to initiate, record, and process journal entries in the general ledger; and to record recurring and nonrecurring adjustments to the financial statements (for example, consolidating adjustments, report combinations, and reclassifications).

- Evaluating the likelihood that failure of the control could result in a misstatement and the degree to which other controls, if effective, achieve the same control objectives.

- Determining the locations or business units to include in the evaluation for a company with multiple locations or business units (see paragraphs B1 through B16).

- Evaluating the design effectiveness of controls.

- Evaluating the operating effectiveness of controls based on procedures sufficient to assess their operating effectiveness. Examples of such procedures include testing of the controls by internal audit, testing of controls by others under the direction of management, using a service organization's reports (see paragraphs B24 through B39), or testing by means of a self-assessment process. Inquiry alone is not adequate to complete this evaluation. To evaluate the effectiveness of the company's internal control over financial reporting, management must have evaluated controls over all relevant assertions related to all significant accounts and disclosures.

- Determining the deficiencies in internal control over financial reporting that are of such a magnitude and likelihood of occurrence that they constitute significant deficiencies or material weaknesses.
- Communicating findings to the auditor and to others, if applicable.
- Evaluating whether findings are reasonable and support management's assessment.

42. As part of the understanding and evaluation of management's process, the auditor should obtain an understanding of the results of procedures performed by others. Others include internal audit and third parties working under the direction of management, including other auditors and accounting professionals engaged to perform procedures as a basis for management's assessment.

43. *Documentation.* When determining whether management's documentation provides reasonable support for its assessment, the auditor should evaluate whether such documentation includes the following:

- The design of controls over relevant assertions related to all significant accounts and disclosures in the financial statements. The documentation should include the five components of internal control over financial reporting as discussed in paragraph 50,
- Information about how significant transactions are initiated, recorded, processed and reported,
- Enough information about the flow of transactions to identify where material misstatements due to error or fraud could occur,
- Controls designed to prevent or detect fraud, including who performs the controls and the related segregation of duties,
- Controls over the period-end financial reporting process,
- Controls over safeguarding of assets (see paragraphs C1 through C3), and
- The results of management's testing and evaluation.

44. Documentation might take many forms of presentation and can include a variety of information, including policy manuals, process models, flowcharts, job descriptions, documents, and forms. No one form of documentation is required, and the extent of documentation will vary depending on the size, nature, and complexity of the company.

45. Documentation of the design of controls over relevant assertions related to significant accounts and disclosures is evidence that controls related to management's assessment about the effectiveness of internal control over financial reporting, including changes to those controls, have been identified, are capable of being communicated to those responsible for their performance, and are capable of being monitored by the company. Such documentation also provides the foundation for appropriate communication concerning responsibilities for performing controls and for the company's evaluation of and monitoring of the effective operation of controls.

46. Inadequate documentation of the design of controls over relevant assertions related to significant accounts and disclosures is a deficiency in the company's internal control over financial reporting. As discussed in paragraph 125, the auditor should evaluate this documentation deficiency. The auditor might conclude that the deficiency is only a deficiency, or that the deficiency represents a significant deficiency or a material weakness. In evaluating the deficiency as to its significance, the auditor should determine whether management can demonstrate the monitoring component of internal control over financial reporting in the absence of documentation.

47. Inadequate documentation also could cause the auditor to conclude that there is a limitation on the scope of the engagement.

Obtaining an Understanding of Internal Control Over Financial Reporting[11]

48. The auditor should obtain an understanding of the *design* of specific controls by applying procedures that include:

- Making inquiries of appropriate management, supervisory, and staff personnel,
- Inspecting company documents,
- Observing the application of specific controls, and
- Tracing transactions through the information system relevant to financial reporting.

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[11] For additional information with regard to special internal control considerations for small and medium-sized companies, see Appendix E.

49. The auditor could also apply additional procedures to obtain an understanding of the design of specific controls.

50. The auditor must obtain an understanding of the design of controls related to each component of internal control over financial reporting, as discussed below.

- *Control Environment.* Because of the pervasive effect of the control environment on the reliability of financial reporting, the auditor's preliminary judgment about its effectiveness often influences the nature, timing, and extent of the tests of operating effectiveness considered necessary. Weaknesses in the control environment should cause the auditor to alter the nature, timing, or extent of tests of operating effectiveness that otherwise would have been performed.

- *Risk Assessment.* When obtaining an understanding of the company's risk assessment process, the auditor should evaluate whether management has identified the risks of material misstatement in the significant accounts and disclosures and related assertions of the financial statements and has implemented controls to prevent or detect material misstatements. For example, the risk assessment process should address how management considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements. Risks relevant to reliable financial reporting also relate to specific events or transactions.

- *Control Activities*. The auditor's understanding of control activities relates to the controls that management has implemented to prevent or detect material misstatement in the accounts and disclosures and related assertions of the financial statements. For the purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained for the financial statement audit.

- *Information and Communication*. The auditor's understanding of management's information and communication involves understanding the same systems and processes that he or she addresses in an audit of financial statements. In addition, this understanding includes a greater emphasis on comprehending the safeguarding controls and the processes for authorization of transactions and the maintenance of records, as well as the period-end financial reporting process (discussed further beginning at paragraph 71).

- *Monitoring***.** The auditor's understanding of management's monitoring of controls extends to and includes its monitoring of all controls, including control activities, which management has identified and designed to prevent or detect material misstatement in the accounts and disclosures and related assertions of the financial statements.

51. Some controls (such as company-level controls, described in paragraph 53) might have a pervasive effect on achieving many overall objectives of the control criteria. For example, information technology general controls over program development, program changes, computer operations, and access to programs and data help ensure that specific controls over the processing of transactions are operating effectively. In contrast, other controls are designed to achieve specific objectives of the control criteria. For example, management generally establishes specific controls, such as accounting for all shipping documents, to ensure that all valid sales are recorded.

52. The auditor should focus on combinations of controls, in addition to specific controls in isolation, in assessing whether the objectives of the control criteria have been achieved. The absence or inadequacy of a specific control designed to achieve the objectives of a specific criterion might not be a deficiency if other controls specifically address the same criterion. Further, when one or more controls achieve the objectives of a specific criterion, the auditor might not have to evaluate other controls designed to achieve those same objectives.

53. *Identifying Company-Level Controls.* Company-level controls are controls such as the following:

- Control environment, including tone at the top, the assignment of authority and responsibility, consistent policies and procedures, and company-wide programs, such as codes of conduct and fraud prevention, that apply to all locations and business units,
- Management's risk assessment process,
- Centralized processing and controls, including shared service environments,
- Monitoring results of operations,
- Monitoring of controls, including activities of the internal audit function, the audit committee, and self-assessment programs,
- The period-end financial reporting process, and
- Board-approved policies that address significant business control and risk management practices.

54. Controls that exist at the company-level often have a pervasive impact on controls at the process, transaction, or application level. For that reason, as a practical consideration, it may be appropriate for the auditor to test and evaluate the design effectiveness of company-level controls first, because the results of that work might affect the way the auditor evaluates the other aspects of internal control over financial reporting.

55. Testing company-level controls alone is not sufficient for the purpose of expressing an opinion on the effectiveness of a company's internal control over financial reporting.

56. *Evaluating the Effectiveness of the Audit Committee's Oversight of the Company's External Financial Reporting and Internal Control Over Financial Reporting.*[12] The company's audit committee plays an important role within the control environment and monitoring components of internal control over financial reporting. Within the control environment, the existence of an effective audit committee is essential to setting a positive tone at the top. Within the monitoring component, an effective audit committee is crucial to challenging the company's activities in the financial arena.

57. The auditor should evaluate factors related to the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting, including:

- Independence of the audit committee members from management (see paragraph 58),
- Clarity with which the audit committee's responsibilities are articulated and how well the audit committee and management understand those responsibilities,
- Level of involvement and interaction with the independent auditor, including the committee's role in the appointment, retention, and compensation of the independent auditor,
- Level of involvement and interaction with internal audit, including the committee's line of authority and role in appointing and compensating employees in the internal audit function,
- Committee's compliance with applicable listing standards adopted pursuant to Section 301 of the Act,

12 If no such committee exists with respect to the company, all references to the audit committee in this standard apply to the entire board of directors of the company.

- Whether the committee includes one or more financial experts as described in Section 407 of the Act, and

- Amount of time that the audit committee devotes to control issues, as well as the amount of time that audit committee members are able to devote to committee activity.

58. As part of evaluating the independence of committee members, the auditor should evaluate how audit committee members are nominated and selected and whether they act independently from management.[13] Generally, the more independence that is built into the process of nominating members of the audit committee to the board, the more the auditor can be assured of committee independence. For example, are qualified candidates identified by outsiders, such as an outside search firm or a nominating committee composed of outside directors, or does management pick "friends?" Are board candidates for the audit committee selected based upon desired skill sets?

59. Ineffective oversight by the audit committee of the company's external financial reporting and internal control over financial reporting should be regarded as at least a significant deficiency and is a strong indicator that a material weakness in internal control over financial reporting exists.

60. *Identifying Significant Accounts.* The auditor should identify significant accounts and disclosures, first at the financial statement level and then at the account or disclosure component level. Determining specific controls to test begins by identifying significant accounts and disclosures within the financial statements. When identifying significant accounts, the auditor should evaluate both quantitative and qualitative factors.

61. An account is significant if there is more than a remote likelihood that the account could contain misstatements that individually or when aggregated with others could have a material effect on the financial statements. Other accounts may be significant on a qualitative basis based on the expectations of a reasonable user. For example, investors might be interested in a particular financial statement account even though it is not quantitatively large because it represents an important performance measure in a specialized industry.

62. Components of an account balance subject to differing risks (inherent and control) or different controls should be considered separately as potential significant accounts.

[13] The auditor should be aware that elections to the board of directors may be governed by state law, SRO listing standards, and the SEC's Regulation 14A.

For instance, inventory accounts often consist of raw materials (purchasing process), work in process (manufacturing process), finished goods (distribution process), and an allowance for obsolescence.

63. In some cases, separate components of an account may also need to be considered a significant account because of the company's organizational structure. For example, for a company that has a number of separate business units, each with unique management and accounting processes, the accounts at each separate business unit are considered individually as potential significant accounts.

64. An account may also be considered significant because of the exposure to unrecognized obligations represented by the account. For example, loss reserves related to a captive insurance entity or self-insurance program may have historically been insignificant in amount yet might represent a more than remote likelihood of material misstatement due to the existence of material unrecorded claims.

65. Appendix B, paragraphs B17 through B19, contains additional requirements about determining which accounts and disclosures are significant.

66. *Identifying Relevant Financial Statement Assertions.* For each significant account, the auditor should determine the relevance of each of these financial statement assertions:[14]

- Existence or occurrence,
- Completeness,
- Valuation or allocation,
- Rights and obligations, and
- Presentation and disclosure.

67. To identify relevant assertions, the auditor should determine the source of likely potential misstatements in each significant account. In determining whether a particular assertion is relevant to a significant account balance or disclosure, the auditor should evaluate:

- The nature of the assertion,

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[14] See AU sec. 326, *Evidential Matter*, which provides additional information on financial statement assertions.

- The volume of transactions or data related to the assertion, and

- The nature and complexity of the systems, including the use of information technology by which the company processes and controls information supporting the assertion.

68. *Relevant assertions* are assertions that have a meaningful bearing on whether the account is fairly stated. For example, valuation may not be relevant to the cash account unless currency translation is involved; however, existence and completeness are always relevant. Similarly, valuation may not be relevant to the gross amount of the accounts receivable balance, but is relevant to the related allowance accounts. Additionally, the auditor may focus on the *presentation and disclosure* assertion separately in connection with the period-end financial reporting process.

69. *Identifying Significant Processes.* The auditor should identify each significant process over each major class of transactions affecting significant accounts or groups of accounts. For each significant process, the auditor should:

- Understand the flow of transactions, including how transactions are initiated, recorded, processed, and reported.

- Identify the points within the process where a misstatement – including a misstatement due to fraud – related to each relevant financial statement assertion could arise.

- Identify the controls that management has implemented to address these potential misstatements.

- Identify the controls that management has implemented over the prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets.

70. The nature and characteristics of a company's use of information technology in its information system affect the company's internal control over financial reporting. Paragraphs 16 through 20 of AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit,* discusses the effect of information technology on internal control over financial reporting.

71. *Understanding the Period-end Financial Reporting Process*. The period-end financial reporting process includes the following:

- The procedures used to enter transaction totals into the general ledger;

- The procedures used to initiate, record, and process journal entries in the general ledger;

- Other procedures used to record recurring and nonrecurring adjustments to the financial statements, such as consolidating adjustments, report combinations, and classifications; and

- Procedures for drafting financial statements and related disclosures.

72. As part of understanding and evaluating the period-end financial reporting process, the auditor should evaluate:

- The inputs, procedures performed, and outputs of the processes the company uses to produce its financial statements,

- The extent of information technology involvement in each period-end financial reporting process element,

- Who participates from management,

- The number of locations involved,

- Types of adjusting entries (for example, standard, nonstandard, eliminating, and consolidating), and

- The nature and extent of the audit committee's involvement in the process.

73. The period-end financial reporting process is always a significant process because of its importance to financial reporting and to the auditor's opinions on internal control over financial reporting and the financial statements. The auditor's understanding of the company's period-end financial reporting process and how it interrelates with the company's other significant processes assists the auditor in identifying and testing controls that are the most relevant to financial statement risks.

74. *Identifying Controls to Test.* The auditor should obtain evidence about the effectiveness of controls (either by performing tests of controls himself or herself, or by using the work of others)[15] for all relevant assertions related to all significant accounts and disclosures in the financial statements. After identifying significant accounts, relevant assertions, and significant processes, the auditor should evaluate the following to identify the controls to be tested:

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[15] See paragraphs 103-110 for additional direction on using the work of others.

- Where errors or fraud could occur,

- The nature of the controls implemented by management,

- The significance of each control in achieving the objectives of the control criteria and whether more than one control achieves a particular objective,

- The nature and extent of tests of the operating effectiveness of the controls performed by the company, if any, and

- The risk that the controls might not be operating effectively. Factors that affect whether the control might not be operating effectively include the following:

  — Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness,

  — Whether there have been changes in the design of controls,

  — The degree to which the control relies on the effectiveness of other controls (for example, the control environment or information technology general controls),

  — Whether there have been changes in key personnel who perform the control or monitor its performance,

  — Whether the control relies on performance by an individual or is automated, and

  — The complexity of the control.

75. The auditor should clearly link individual controls with the significant accounts and assertions to which they relate.

76. The auditor should evaluate whether to test preventive controls, detective controls, or a combination of both for individual relevant assertions for individual significant accounts. For instance, when performing tests of preventive and detective controls, the auditor might conclude that a deficient preventive control could be compensated for by an effective detective control and, therefore, not result in a significant deficiency or material weakness. For example, a monthly reconciliation control procedure, which is a detective control, might detect an out-of-balance situation resulting from an unauthorized transaction being initiated due to an ineffective authorization procedure, which is a preventive control. When determining whether the detective control is

effective, the auditor should evaluate whether the detective control is sufficient to achieve the control objective to which the preventive control relates.

77. Because effective internal control over financial reporting often includes a combination of preventive and detective controls, the auditor ordinarily will test a combination of both.

78. The auditor should apply tests of controls to those controls that are important to achieving each control objective. It is neither necessary to test all controls nor is it necessary to test redundant controls (that is, controls that duplicate other controls that achieve the same objective and already have been tested), unless redundancy is itself a control objective, as in the case of certain computer controls.

79. *Performing Walkthroughs.* Walkthroughs are required procedures. The auditor should perform a walkthrough for all of the company's significant processes. In a walkthrough, the auditor should trace all types of transactions and events, both recurring and unusual, from origination through the company's information systems until they are reflected in the company's financial reports. Walkthroughs provide the auditor with evidence to:

- Confirm the auditor's understanding of the process flow of transactions,

- Confirm the auditor's understanding of the design of controls identified for all five components of internal control over financial reporting, including those related to the prevention or detection of fraud,

- Confirm that the auditor's understanding of the process is complete by determining whether all points in the process where misstatements related to each relevant financial statement assertion that could occur have been identified,

- Evaluate the effectiveness of the design of controls, and

- Confirm whether controls have been placed in operation.

80. The auditor's walkthroughs should encompass the entire process of initiating, recording, processing, and reporting individual transactions, and controls for all five internal control components and fraud, not just control activities. During the walkthrough, at each point where important processing procedures or controls occur, the auditor should question the company's personnel about their understanding of what is required by the company's prescribed procedures and controls and determine whether the processing procedures are performed as originally understood and on a timely basis. (Controls might not be performed regularly but still be timely.) During the

walkthrough, the auditor should be alert for exceptions to the company's prescribed procedures and controls.

81. While performing a walkthrough, the auditor should evaluate the quality of the evidence obtained and perform walkthrough procedures that produce a level of evidence consistent with the objectives listed in paragraph 79. Rather than reviewing copies of documents and making inquiries of a single person at the company, the auditor should follow the process flow using the same documents and information technology that company personnel use and make inquiries of relevant personnel involved in significant aspects of the process or controls. To corroborate information at various points in the walkthrough, the auditor might ask personnel to describe their understanding of the previous and succeeding processing or control activities and to demonstrate what they do. In addition, inquiries should include follow-up questions that could help identify the abuse of controls or indicators of fraud. Examples of follow-up inquiries include asking personnel:

- What they do when they find an error or what they are looking for to determine if there is an error (rather than simply asking them if they perform listed procedures and controls); what kind of errors they have found; what happened as a result of finding the errors, and how the errors were resolved. If the person being interviewed has never found an error, the auditor should evaluate whether that is due to good preventive controls or whether the individual performing the control lacks the necessary skills.

- Whether they have ever been asked to override the process or controls, and if so, to describe the situation, why it occurred, and what happened.

82. During the period under audit, when there have been significant changes in the process flow of transactions, including the supporting computer applications, the auditor should evaluate the nature of the change(s) and the effect on related accounts to determine whether to walkthrough transactions that were processed both before and after the change.

83. For non-routine and estimation processes, the auditor can often gain an understanding of the transaction flow, identify and understand controls, and conduct the walkthrough simultaneously.

Testing and Evaluating Design Effectiveness

84. Internal control over financial reporting is effectively designed when the controls complied with would be expected to prevent or detect material misstatements in the financial statements. The auditor should determine whether the company has controls to meet the objectives of the control criteria by:

- Identifying the company's control objectives in each area,

- Identifying the controls that satisfy each objective, and

- Determining whether the controls, if operating properly, can effectively prevent or detect material misstatements in the financial statements.

85. Procedures the auditor performs to test and evaluate design effectiveness include inquiry, observation, walkthroughs, and a specific evaluation of whether the controls are likely to prevent or detect misstatements if they are operated as prescribed by appropriately qualified persons.

86. The procedures that the auditor performs in evaluating management's assessment process and obtaining an understanding of internal control over financial reporting also provide the auditor with evidence about the design effectiveness of internal control over financial reporting.

87. The procedures the auditor performs to test and evaluate design effectiveness also might provide evidence about operating effectiveness.

Testing and Evaluating Operating Effectiveness

88. An auditor should evaluate the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and qualifications to perform the control effectively.

89. *Nature of Tests of Controls.* Tests of controls over operating effectiveness should include a mix of inquiries of appropriate personnel, inspection of relevant documentation, observation of the company's operations, and reperformance of the application of the control. For example, the auditor might observe the procedures for opening the mail and processing cash receipts to test the operating effectiveness of controls over cash receipts. Because an observation is pertinent only at the point in time at which it is made, the auditor should supplement the observation with inquiries of company personnel and inspection of documentation about the operation of such controls at other times.

90. Inquiry is a procedure that is used extensively throughout the audit and often is complementary to performing other procedures. Inquiry consists of seeking information, both financial and nonfinancial, of knowledgeable persons throughout the company. Inquiries may range from formal written inquiries to informal oral inquiries.

91. Evaluating responses to inquiries is an integral part of the inquiry procedure. Responses to inquiries might provide the auditor with information not previously possessed or with corroborative evidence. Alternatively, responses might provide information that differs significantly from other information the auditor obtains (for example, information regarding the possibility of management override of controls). In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional procedures.

92. Because inquiry alone does not provide sufficient evidence to support the operating effectiveness of a control, the auditor should perform additional tests of controls. For example, if the company implements a control activity whereby its sales manager reviews and investigates a report of invoices with unusually high or low gross margins, inquiry of the sales manager as to whether he or she investigates discrepancies would be inadequate. To obtain sufficient evidence about the operating effectiveness of the control, the auditor should corroborate the sales manager's responses by performing other procedures, such as inspecting reports or other documentation used in or generated by the performance of the control, and evaluate whether appropriate actions were taken regarding discrepancies.

93. The nature of the control also influences the nature of the tests of controls the auditor can perform. For example, the auditor might examine documents regarding controls for which documentary evidence exists. However, documentary evidence regarding some aspects of the control environment, such as management's philosophy and operating style, might not exist. In circumstances in which documentary evidence of controls or the performance of controls does not exist and is not expected to exist, the auditor's tests of controls would consist of inquiries of appropriate personnel and observation of company activities. As another example, a signature on a voucher package to indicate that the signer approved it does not necessarily mean that the person carefully reviewed the package before signing. The package may have been signed based on only a cursory review (or without any review). As a result, the quality of the evidence regarding the effective operation of the control might not be sufficiently persuasive. If that is the case, the auditor should reperform the control (for example, checking prices, extensions, and additions) as part of the test of the control.

94. *Timing of Tests of Controls.* The auditor must perform tests of controls over a period of time that is adequate to determine whether, as of the date specified in management's report, the controls necessary for achieving the objectives of the control criteria are operating effectively. The period of time over which the auditor performs tests of controls varies with the nature of the controls being tested and with the frequency with which specific controls operate and specific policies are applied. Some controls operate continuously (for example, controls over sales), while others operate

only at certain times (for example, controls over the preparation of monthly or quarterly financial statements and controls over physical inventory counts).

95. The auditor's testing of the operating effectiveness of such controls should occur at the time the controls are operating. Controls "as of" a specific date encompass controls that are relevant to the company's internal control over financial reporting "as of" that specific date, even though such controls might not operate until after that specific date. For example, some controls over the period-end financial reporting process normally operate only after the "as of" date. Therefore, if controls over the December 31, 20X4 period-end financial reporting process operate in January 20X5, the auditor tests the control operating in January 20X5 to have sufficient evidence of operating effectiveness "as of" December 31, 20X4.

96. When the auditor reports on the effectiveness of controls "as of" a specific date and obtains evidence about the operating effectiveness of controls at an interim date, he or she should determine what additional evidence to obtain concerning the operation of the control for the remaining period. In making that determination, the auditor should evaluate:

- The specific controls tested prior to the "as of" date and the results of those tests,
- The degree to which evidence about the operating effectiveness of those controls was obtained,
- The length of the remaining period, and
- The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date.

97. The auditor could also evaluate additional factors when determining what additional evidence to obtain.

98. For controls over significant nonroutine transactions, controls over accounts or processes with a high degree of subjectivity or judgment in measurement, or controls over the recording of period-end adjustments, the auditor should perform tests of controls closer to or at the "as of" date rather than at an interim date. However, the auditor should balance performing the tests of controls closer to the "as of" date with the need to obtain sufficient evidence of operating effectiveness.

99. Prior to the date specified in management's report, management might implement changes to the company's controls to make them more effective or efficient or to address control deficiencies. In that case, the auditor might not need to evaluate controls that have been superseded. For example, if the auditor determines that the

new controls achieve the related objectives of the control criteria and have been in effect for a sufficient period to permit the auditor to assess their design and operating effectiveness by performing tests of controls,[16] he or she will not need to evaluate the design and operating effectiveness of the superseded controls for purposes of expressing an opinion on internal control over financial reporting.

100. As discussed in paragraph 190, however, the auditor must communicate any identified significant deficiencies and material weaknesses in controls to the audit committee in writing. In addition, the auditor should evaluate how the design and operating effectiveness of the superseded controls relates to the auditor's reliance on controls for financial statement audit purposes.

101. *Extent of Tests of Controls.* Each year the auditor must obtain sufficient evidence about whether the company's internal control over financial reporting, including the controls for all internal control components, is operating effectively. The auditor also should vary from year to year the nature, timing, and extent of testing of controls to introduce unpredictability into the testing and respond to changes in circumstances. For example, each year the auditor might test the controls at a different interim period; increase or reduce the number and types of tests performed; or change the combination of procedures used.

102. In determining the extent of procedures to perform, the auditor should design the procedures to provide a high level of assurance that the control being tested is operating effectively. In making this determination, the auditor should consider the following factors:

- *Nature of the control*. Manual controls should be subjected to more extensive testing than automated controls. In some circumstances, testing a single operation of an automated control may be sufficient to obtain a high level of assurance that the control operated effectively, provided that information technology general controls also are operating effectively. For manual controls, sufficient evidence about the operating effectiveness of the controls is obtained by evaluating multiple operations of the control and the results of each operation. The auditor also should consider the complexity of the controls, the significance of the judgments that must be made in connection with their operation, and the level of competence of the person performing the controls that is necessary for the control to operate effectively. As the complexity and level of judgment

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[16] Paragraph 166 provides reporting directions in circumstances when the auditor has not been able to obtain evidence that the new controls were appropriately designed or have been operating effectively for a sufficient period of time.

increase or the level of competence of the person performing the control decreases, the extent of the auditor's testing should increase.

- *Frequency of operation*. The more frequently a manual control operates, the more operations of the control the auditor should test. For example, for a manual control that operates in connection with each transaction, the auditor tests multiple operations of the control over a sufficient period of time to obtain a high level of assurance that the control operated effectively. For controls that operate less frequently, such as monthly account reconciliations and controls over the period-end financial reporting process, the auditor may test significantly fewer operations of the control. However, the auditor's evaluation of each operation of controls operating less frequently is likely to be more extensive. For example, when evaluating the operation of a monthly exception report, the auditor should evaluate whether the judgments made with regard to the disposition of the exceptions were appropriate and adequately supported.

- *Importance of the control*. Controls that are relatively more important should be tested more extensively. For example, some controls may address multiple financial statement assertions, and certain period-end detective controls might be considered more important than related preventive controls. The auditor should test more operations of such controls or, if such controls operate infrequently, the auditor should evaluate each operation of the control more extensively.

103. *Use of the Work of Management and Others.* The auditor should evaluate whether to use the work performed by management and others. When evaluating whether to use the results of procedures performed by others, the auditor should evaluate the following factors:

- The materiality or the risk of misstatement of the accounts and disclosures that the controls address.

- The degree of judgment required to evaluate the operating effectiveness of the control.

- The degree the control can be subjected to objective testing vs. a subjective evaluation.

- The pervasiveness of the control.

- The level of judgment or estimation that is required in the account or disclosure.

104. There are a number of areas in which the auditor should not use the results of testing performed by management and others, including:

- Controls that are part of the control environment, including controls specifically established to prevent and detect fraud that is reasonably likely to result in material misstatement of the financial statements.

- Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; to initiate, record, and process journal entries in the general ledger; and to record recurring and nonrecurring adjustments to the financial statements (for example, consolidating adjustments, report combinations, and reclassifications).

- 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.

- Walkthroughs, as discussed beginning at paragraph 79.

105. The auditor's use of the results of procedures performed by management and others should be limited in the following areas:

- Controls over significant nonroutine and nonsystematic transactions (such as accounts involving *significant* judgments and estimates).

- Controls over significant accounts, processes, or disclosures where the auditor has assessed the risk of failure of the controls to operate effectively as high.

106. The auditor might decide to use the results of tests performed by management and others within the company in other areas, such as controls over routine processing of significant accounts and disclosures, without specific limitation.

107. If the auditor intends to use the results of tests performed by others to alter the nature, timing, and extent of the tests of controls that the auditor performs, he or she should assess the degree of objectivity and competence of the individuals performing the tests of controls. In addition to assessing the objectivity and competence of those performing the tests, the auditor should reperform some of the tests of controls originally performed by others.

108. Internal auditors would normally be expected to have greater competence with regard to internal control over financial reporting and objectivity than other company personnel. Therefore, the auditor may be able to use the results of their procedures to a greater extent than the results of procedures performed by others. This is particularly

true in the case of internal auditors who follow the *International Standards for the Professional Practice of Internal Auditing* issued by the Institute of Internal Auditors. At companies where the importance of the internal audit function results in a high degree of competence and objectivity and their work is extensive, the auditor could use their work to the greatest extent an auditor could use the work of others. On the other hand, if, for example, internal audit reports solely to management, which would reduce internal audit's objectivity, or if limited resources allocated to internal audit result in very limited testing procedures on its part, the auditor would need to perform more testing himself or herself.

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.

110. Appendix B, paragraphs B20 through B23, provides additional guidance as well as an application example on using the work of others.

111. *Use of Professional Skepticism when Evaluating the Results of Testing.* The auditor must conduct the audit of internal control over financial reporting and the audit of the financial statements with professional skepticism, which is an attitude that includes a questioning mind and a critical assessment of audit evidence. For example, even though a control is performed by the same employee whom the auditor believes performed the control effectively in prior periods, the control may not be operating effectively during the current period because the employee could have become complacent, distracted, or otherwise not effectively carry out his or her responsibilities. Also, regardless of any past experience with the entity or the auditor's beliefs about management's honesty and integrity, the auditor should recognize the possibility that a material misstatement due to fraud could be present. Furthermore, professional skepticism requires the auditor to consider whether evidence obtained suggests that a material misstatement due to fraud has occurred. In exercising professional skepticism in gathering and evaluating evidence, the auditor must not be satisfied with less-than-persuasive evidence because of a belief that management is honest.

112. When the auditor identifies exceptions to the company's prescribed control procedures, he or she should determine, using professional skepticism, the effect of the exception on the nature and extent of additional testing that may be appropriate or necessary and on the operating effectiveness of the control being tested. A conclusion that an identified exception does not represent an internal control deficiency is appropriate only if evidence beyond what the auditor had initially planned and beyond inquiry supports that conclusion.

Forming an Opinion on the Effectiveness of Internal Control Over Financial Reporting

113. When forming an opinion on internal control over financial reporting, the auditor should evaluate all evidence obtained from all sources, including:

- The results of tests of controls,

- The results of substantive procedures performed during the financial statement audit, and

- Any identified internal control deficiencies.

114. As part of this evaluation, the auditor should review all reports issued during the year by internal audit (or similar functions, such as loan review in a financial institution) that address controls related to internal control over financial reporting and evaluate any internal control deficiencies identified in those reports. This review should include reports issued by internal audit as a result of operational audits or specific reviews of key processes if those reports address controls related to internal control over financial reporting.

115. *Circumstances for Issuance of Unqualified Opinion.* The auditor may issue an unqualified opinion only when there are no identified material weaknesses and when there have been no restrictions on the scope of the auditor's work. The existence of a material weakness in internal control over financial reporting requires the auditor to express an adverse opinion (see paragraph 162), while a scope limitation requires the auditor to express a qualified opinion or a disclaimer of opinion, depending on the significance of the limitation in scope (see paragraph 165). The following paragraphs provide directions on evaluating internal control deficiencies noted during the audit.

116. *Evaluating Deficiencies in Internal Control Over Financial Reporting.* The auditor must evaluate identified internal control deficiencies and determine whether the deficiencies, individually or in combination, are significant deficiencies or material weaknesses.

117. The auditor should evaluate the significance of a deficiency in internal control over financial reporting initially by determining the following:

- The likelihood that a deficiency, or a combination of deficiencies, could result in a misstatement of an account balance or disclosure, and

- The magnitude of the potential misstatement resulting from the deficiency or deficiencies.

118. The significance of a deficiency in internal control over financial reporting depends on the *potential* for a misstatement, not on whether a misstatement actually has occurred.

119. Several factors affect the *likelihood* that a deficiency, or a combination of deficiencies, could result in a misstatement of an account balance or disclosure. The factors include, but are not limited to, the following:

- The susceptibility of the related assets or liability to loss or fraud; that is, greater susceptibility increases risk.

- The subjectivity, complexity, or extent of judgment required to determine the amount involved; that is, greater subjectivity, complexity, or judgment, like that related to an accounting estimate, increases risk.

- The nature of the accounts, processes, or disclosures; for example, suspense accounts and related party transactions involve greater risk.

- The cause and frequency of known or detected exceptions for the operating effectiveness of a control; for example, a control with an observed non-negligible deviation rate is a deficiency.

- The interaction or relationship of the control with other controls; that is, the interdependence or redundancy of the control.

120. When evaluating the likelihood that a deficiency or combination of deficiencies could result in a misstatement, the auditor should evaluate how the controls interact with other controls. There are controls, such as information technology general controls, on which other controls depend. Some controls function together as a group of controls. Other controls overlap, in the sense that these other controls achieve the same objective.

121. Several factors affect the magnitude of the misstatement that could result from a deficiency or deficiencies in controls. The factors include, but are not limited to, the following:

- The financial statement amounts or total of transactions that are exposed to the deficiency.

- The volume of activity in the account balance or class of transactions exposed to the deficiency that has occurred in the current period, or that is expected in future periods.

122. In evaluating the magnitude of the potential misstatement, the auditor should recognize that the maximum amount that an account balance or total of transactions can be overstated is generally the recorded amount. However, the recorded amount is not a limitation on the amount of potential understatement. The auditor also should recognize that the risk of misstatement might be different for the maximum possible misstatement than for lesser possible amounts.

123. The interaction of qualitative considerations that affect internal control over financial reporting with quantitative considerations ordinarily results in deficiencies in the following areas being at least significant deficiencies in internal control over financial reporting:

- Controls over the selection and application of accounting policies that are in conformity with generally accepted accounting principles,
- Antifraud programs and controls,
- Controls over non-routine and nonsystematic transactions, and
- Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; initiate, record, and process journal entries into the general ledger; and record recurring and nonrecurring adjustments to the financial statements.

124. When evaluating the significance of a deficiency in internal control over financial reporting, the auditor also should determine the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles. If the auditor determines that the deficiency would prevent prudent officials in the conduct of their own affairs from concluding that they have reasonable assurance,[17] then the auditor should consider the deficiency to be at least a significant deficiency. Having determined in this manner that a deficiency represents a significant deficiency, the auditor must further evaluate the deficiency to determine whether individually, or in combination with other deficiencies, the deficiency is a material weakness.

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[17] See SEC Staff Accounting Bulletin Topic 1M2, *Immaterial Misstatements That Are Intentional,* for further discussion about the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs.

125. Inadequate documentation of the design of controls and the absence of sufficient documented evidence to support management's assessment of the operating effectiveness of internal control over financial reporting also are internal control deficiencies. As with other internal control deficiencies, the auditor should evaluate these deficiencies as to their significance.

126. Each of the following circumstances should be regarded as at least a significant deficiency and is a strong indicator that a material weakness in internal control over financial reporting exists:

- Restatement of previously issued financial statements to reflect the correction of a misstatement.

- Identification by the auditor of a material misstatement in financial statements in the current period that was not initially identified by the company's internal control over financial reporting. (This is still a strong indicator of a material weakness even if management subsequently corrects the misstatement.)

- Oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective. (Paragraphs 56 through 59 present factors to evaluate when determining whether the audit committee is ineffective.)

- For larger, more complex entities, the internal audit function or the risk assessment function is ineffective.

- For complex entities in highly regulated industries, an ineffective regulatory compliance function.

- Identification of fraud of any magnitude on the part of senior management.

- Significant deficiencies that have been communicated to management and the audit committee remain uncorrected after some reasonable period of time.

127. In addition, Appendix D provides examples of significant deficiencies and material weaknesses.

Requirement for Written Representations

128. In an audit of internal control over financial reporting, the auditor should obtain written representations from management:

a. Acknowledging management's responsibility for establishing and maintaining effective internal control over financial reporting,

b. Stating that management has performed an evaluation of the effectiveness of the company's internal control over financial reporting and specifying the control criteria,

c. Stating management's conclusion about the effectiveness of the company's internal control over financial reporting based on the control criteria as of a specified date,

d. Stating that management has disclosed to the auditor all significant deficiencies in the design or operation of internal control over financial reporting that it believes to be material weaknesses in internal control over financial reporting,

e. Describing any material fraud and any other fraud that, although not material, involves senior management or management or other employees who have a significant role in the company's internal control over financial reporting,

f. Stating whether internal control deficiencies identified and communicated to the audit committee during previous engagements pursuant to paragraph 190 have been resolved, and specifically identifying any that have not, and

g. Stating whether there were, subsequent to the date being reported on, any changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses.

129. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion. As discussed further in paragraph 165, when management limits the scope of the audit, the auditor should either withdraw from the engagement or disclaim an opinion. Further, the auditor should evaluate the effects of management's refusal on his or her ability to rely on other representations, including, if applicable, representations obtained in an audit of the company's financial statements.

130. AU sec. 333, *Management Representations*, explains matters such as who should sign the letter, the period to be covered by the letter, and when to obtain an updating letter.

Relationship of an Audit of Internal Control over Financial Reporting to an Audit of Financial Statements

131. The audit of internal control over financial reporting should be integrated with the audit of the financial statements. The objectives of the procedures for the audits are not identical, however, and the auditor must plan and perform the work to achieve the objectives of both audits.

132. The understanding of internal control over financial reporting the auditor obtains and the procedures the auditor performs for purposes of expressing an opinion on management's assessment are interrelated with the internal control over financial reporting understanding the auditor obtains and procedures the auditor performs to assess control risk for purposes of expressing an opinion on the financial statements. As a result, it is efficient for the auditor to coordinate obtaining the understanding and performing the procedures.

Tests of Controls in an Audit of Internal Control Over Financial Reporting

133. The objective of the tests of controls in an audit of internal control over financial reporting is to obtain evidence about the effectiveness of internal controls to support the auditor's opinion on whether management's assessment of the effectiveness of the company's internal control over financial reporting is fairly stated. The auditor's opinion relates to the effectiveness of the company's internal control over financial reporting as of *a point in time* and *taken as a whole*.

134. To express an opinion on internal control over financial reporting effectiveness as of *a point in time*, the auditor should obtain evidence that internal control over financial reporting has operated effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the company's financial statements. To express an opinion on internal control over financial reporting effectiveness *taken as a whole,* the auditor must obtain evidence about the effectiveness of controls related to all relevant assertions for all significant accounts and disclosures in the financial statements. This requires the auditor to test the design and operating effectiveness of controls he or she ordinarily would not test if expressing an opinion only on the financial statements.

135. When concluding on the effectiveness of internal control over financial reporting for purposes of expressing an opinion on management's assessment, the auditor should

incorporate the results of any additional tests of control performed to achieve the objective related to expressing an opinion on the financial statements, as discussed in the following section.

Tests of Controls in an Audit of Financial Statements

136. To express an opinion on the financial statements, the auditor ordinarily performs tests of controls and substantive procedures. The objective of the tests of controls the auditor performs for this purpose is to assess control risk. To assess control risk for specific financial statement assertions at less than the maximum, the auditor is required to obtain evidence that the relevant controls operated effectively during the *entire period* covered by the company's financial statements. However, the auditor is not required to assess control risk at less than the maximum for *all* relevant assertions for the entire period covered by the financial statements, and, for a variety of reasons, the auditor may choose not to do so.[18]

137. When concluding on the effectiveness of controls for the purpose of assessing control risk, the auditor also should consider the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on management's assessment, as discussed in paragraphs 133 through 135. Consideration of these results may require the auditor to alter the nature, timing, and extent of substantive procedures and to plan and perform further tests of controls, particularly in response to identified internal control deficiencies.

Effect of Tests of Controls on Substantive Procedures

138. Regardless of the assessed level of control risk or the assessed risk of material misstatement in connection with the audit of the financial statements, the auditor should perform substantive procedures for all relevant assertions for all significant accounts and disclosures. Performing procedures to express an opinion on internal control over financial reporting does not diminish this requirement.

139. The substantive procedures that the auditor should perform consist of tests of details of transactions and balances and analytical procedures. Before using the results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information. For significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.

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[18] See paragraph 146 for additional documentation requirements when the auditor assesses control risk as other than low.

140. When designing substantive analytical procedures, the auditor also should evaluate the risk of management override of controls. As part of this process, the auditor should evaluate whether such an override might have allowed adjustments outside of the normal period-end financial reporting process to have been made to the financial statements. Such adjustments might have resulted in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions. For this reason, substantive analytical procedures are not well suited to detecting fraud.

141. The auditor's substantive procedures must include reconciling the financial statements to the accounting records and examining material adjustments made during the course of preparing the financial statements. Also, other auditing standards require auditors to perform specific tests of details in the financial statement audit. For instance, AU sec. 316, *Consideration of Fraud in a Financial Statement Audit,* requires the auditor to perform certain tests of details to further address the risk of management override, whether or not a specific risk of fraud has been identified. AU sec. 330.34, *The Confirmation Process*, states that there is a presumption that the auditor will request the confirmation of accounts receivable. Similarly, AU sec. 331.01, *Inventories*, states that observation of inventories is a generally accepted auditing procedure and that the auditor who issues an opinion without this procedure "has the burden of justifying the opinion expressed."

142. If, during the audit of internal control over financial reporting, the auditor identifies an internal control deficiency, he or she should determine the effect on the nature, timing, and extent of substantive procedures to be performed to reduce the risk of material misstatement of the financial statements to an appropriately low level.

Effect of Substantive Procedures on the Auditor's Conclusions About the Operating Effectiveness of Controls

143. In an audit of internal control over financial reporting, the auditor should evaluate the effect of the findings of all substantive auditing procedures performed in the audit of financial statements on the effectiveness of internal control over financial reporting. This evaluation should include, but not be limited to:

- The auditor's risk evaluations in connection with the selection and application of substantive procedures, especially those related to fraud (see paragraph 26),
- Findings with respect to illegal acts and related party transactions,
- Indications of management bias in making accounting estimates and in selecting accounting principles, and

- Misstatements detected by substantive procedures. The extent of such misstatements might alter the auditor's judgment about the effectiveness of controls.

144. However, the absence of misstatements detected by substantive procedures does not provide evidence that controls related to the assertion being tested are effective.

Documentation Requirements

145. In addition to the documentation requirements in AU sec. 339, *Audit Documentation*, the auditor should document:

- The understanding obtained and the evaluation of the design of each of the five components of the company's internal control over financial reporting,

- The process used to determine significant accounts, classes of transactions, and disclosures, including the determination of the locations or business units at which to perform testing,

- The identification of where misstatements related to relevant financial statement assertions could occur within significant accounts, assertions, and processes,

- The extent to which the auditor relied upon work performed by management or others,

- The evaluation of any deficiencies noted as a result of the auditor's testing, and

- Other findings that could result in a modification to the auditor's report.

146. For a company that has effective internal control over financial reporting, the auditor ordinarily will be able to perform sufficient testing of controls to be able to assess control risk related to relevant assertions for significant accounts and disclosures at a low level. If, however, the auditor assesses control risk as other than low for certain assertions or significant accounts, the auditor should document the reasons for that conclusion. Examples of when it is appropriate to not assess control risk as low include:

- When a control over a relevant assertion related to a significant account or disclosure was superseded late in the year and only the new control was tested for operating effectiveness.

- When a material weakness existed during the period under audit and was corrected by the end of the period.

147. The auditor also should document the effect of a conclusion that control risk is other than low for any relevant assertions for any significant accounts on his or her opinion on the audit of internal control over financial reporting.

Reporting on Internal Control Over Financial Reporting

Management's Report

148. Management is required to include in its annual report its assessment of the effectiveness of the company's internal control over financial reporting in addition to its audited financial statements as of the end of the most recent fiscal year. Management's report on internal control over financial reporting is required to include the following:[19]

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company,
- A statement identifying the framework used by management to conduct the required evaluation of the effectiveness of the company's internal control over financial reporting,
- An assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including an explicit statement as to whether that internal control over financial reporting is effective, and
- A statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the company's internal control over financial reporting.

149. Management should provide, both in its report on internal control over financial reporting and in its representation letter to the auditor, a written conclusion about the effectiveness of the company's internal control over financial reporting. The conclusion about the effectiveness of a company's internal control over financial reporting can take many forms, however, management is required to state a direct conclusion about whether the company's internal control over financial reporting is effective. This standard, for example, includes the phrase "management's assessment that W

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[19] Management is required to include these matters in their report. See Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities and Exchange Commission Release No. 33-8238 (June 5, 2003) [68 FR 36636].

Company maintained effective internal control over financial reporting as of [*date*]" to illustrate such a conclusion. Other phrases, such as "management's assessment that W Company's internal control over financial reporting as of [*date*] is sufficient to meet the stated objectives," also might be used. However, the conclusion should not be so subjective (for example, "very effective internal control") that people having competence in and using the same or similar criteria would not ordinarily be able to arrive at similar conclusions.

150. Management is precluded from concluding that the company's internal control over financial reporting is effective if there are one or more material weaknesses. In addition, management is required to disclose all material weaknesses that exist as of the end of the most recent fiscal year.

151. Management might be able to accurately represent that internal control over financial reporting, as of the end of the company's most recent fiscal year, is effective even if one or more material weaknesses existed during the period. To make this representation, management must have changed the internal control over financial reporting to eliminate the material weaknesses sufficiently in advance of the "as of" date and have satisfactorily tested the effectiveness over a period of time that is adequate for it to determine whether, as of the end of the fiscal year, the design and operation of internal control over financial reporting is effective.[20]

Auditor's Evaluation of Management's Report

152. With respect to management's report on its assessment, the auditor should evaluate the following matters:

a. Whether management has properly stated its responsibility for establishing and maintaining adequate internal control over financial reporting.

b. Whether the framework used by management to conduct the evaluation is suitable. (As discussed in paragraph 13, the framework described in COSO constitutes a suitable and available framework.)

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[20] However, when the reason for a change in internal control over financial reporting is the correction of a material weakness, management and the auditor need to evaluate whether the reason for the change and the circumstances surrounding the change are material information necessary to make the disclosure about the change not misleading in a filing subject to certification under Section 302. See discussion beginning at paragraph 183 for further direction.

c. Whether management's assessment of the effectiveness of internal control over financial reporting, as of the end of the company's most recent fiscal year, is free of material misstatement.

d. Whether management has expressed its assessment in an acceptable form.

- Management is required to state whether the company's internal control over financial reporting is effective.

- A negative assurance statement indicating that, "Nothing has come to management's attention to suggest that the company's internal control over financial reporting is not effective," is not acceptable.

- Management is not permitted to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses in the company's internal control over financial reporting.

e. Whether material weaknesses identified in the company's internal control over financial reporting, if any, have been properly disclosed, including those corrected during the period.[21]

Auditor's Report on Management's Assessment of Internal Control Over Financial Reporting

153. The auditor's report on management's assessment of the effectiveness of internal control over financial reporting must include the following elements:

a. A title that includes the word *independent,*

b. An identification of management's conclusion about the effectiveness of the company's internal control over financial reporting as of a specified date based on the control criteria [for example, criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)] ,

c. An identification of the title of the management report that includes management's assessment (the auditor should use the same description of the

[21] See paragraph 189 for direction when a material weakness was corrected during the fourth quarter and the auditor believes that modification to the disclosures about changes in internal control over financial reporting are necessary for the annual certifications to be accurate and to comply with the requirements of Section 302.

company's internal control over financial reporting as management uses in its report),

d. A statement that the assessment is the responsibility of management,

e. A statement that the auditor's responsibility is to express an opinion on the written assessment based on his or her audit,

f. A definition of internal control over financial reporting as stated in paragraph 4,

g. A statement that the audit was conducted in accordance with auditing and related professional practice standards established by the Public Company Accounting Oversight Board (PCAOB),

h. A statement that the PCAOB standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects,

i. A statement that an audit includes obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as the auditor considered necessary in the circumstances,

j. A statement that the auditor believes the audit provides a reasonable basis for his or her opinion,

k. A paragraph stating that, because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate,

l. The auditor's opinion on whether management's assessment of the effectiveness of the company's internal control over financial reporting as of the specified date is fairly stated, in all material respects, based on the control criteria (see discussion beginning at paragraph 148),[22]

m. The manual or printed signature of the auditor's firm,

n. The date of the audit report.

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[22] Nothing precludes the auditor from auditing management's assessment but opining directly on the effectiveness of internal control over financial reporting.

154. Example A-1 in Appendix A is an illustrative auditor's report – an unqualified opinion – on management's assessment of the effectiveness of the company's internal control over financial reporting.

155. *Separate or Combined Reports.* The auditor may choose to issue a combined report (that is, one report containing both an opinion on the financial statements and an opinion on internal control over financial reporting) or separate reports on the company's financial statements and on internal control over financial reporting. Appendix A includes an illustrative combined audit report on internal control over financial reporting and examples of separate reports on internal control over financial reporting.

156. If the auditor chooses to issue a separate report on internal control over financial reporting, he or she should add the following paragraph to the auditor's report on the financial statements:

> We also have audited, in accordance with auditing and related professional practice standards established by the Public Company Accounting Oversight Board, the effectiveness of W Company's internal control over financial reporting as of December 31, 20X3, based on [*identify criteria*] and our report dated [*date of report, which should be the same as the date of the report on the financial statements*] expressed [*include nature of opinion*].

157. *Report Date.* As stated previously, the auditor cannot audit internal control over financial reporting without also auditing the financial statements. Therefore, the reports should be dated the same.

158. When the auditor elects to issue a combined report on the audit of the financial statements and the audit of internal control over financial reporting, the audit opinion will address multiple reporting periods for the financial statements presented but only the end of the most recent fiscal year for management's assessment of the effectiveness of internal control over financial reporting. See a combined report in Example A-6 in Appendix A.

159. *Report Modifications.* The auditor should modify the standard report if any of the following conditions exist.

a. Management's assessment is inadequate or management's report is inappropriate. (See paragraph 161.)

b. There is a material weakness in the company's internal control over financial reporting. (See paragraphs 162 through 164.)

c. There is a restriction on the scope of the engagement. (See paragraphs 165 through 167.)

d. The auditor decides to refer to the report of other auditors as the basis, in part, for the auditor's own report. (See paragraphs 168 and 169.)

e. A significant subsequent event has occurred since the date being reported on. (See paragraphs 170 through 173.)

f. There is other information contained in management's report on internal control over financial reporting. (See paragraphs 174 through 176.)

160. If, for any of the situations listed in the paragraph above, the auditor plans to issue other than an unqualified opinion, the auditor should report directly on the effectiveness of the company's internal control over financial reporting rather than on management's assessment. Expressing an opinion on management's assessment in these circumstances could result in confusion. For example, if management makes an adverse assessment because a material weakness has been identified and not corrected ("…internal control over financial reporting is not effective…") and the auditor expressed his or her opinion on management's assessment ("…management's assessment that internal control over financial reporting is not effective is fairly stated, in all material respects…"), a reader might not be clear about the results of the auditor's testing and about the auditor's conclusions. Reporting directly on the effectiveness of the company's internal control over financial reporting better communicates to report users the effect of such conditions, because direct reporting more clearly states the auditor's conclusions about the effectiveness of internal control over financial reporting ("In our opinion, because of the effect of the material weakness described…, the Company's internal control over financial reporting is not effective.").

161. *Management's Assessment Inadequate or Report Inappropriate.* If the auditor determines that management's process for assessing internal control over financial reporting is inadequate, the auditor should modify his or her opinion for a scope limitation (discussed further beginning at paragraph 165). If the auditor determines that management's report is inappropriate, the auditor should modify his or her report to include, at a minimum, an explanatory paragraph describing the reasons for this conclusion.

162. *Material Weaknesses.* Paragraphs 116 through 127 describe significant deficiencies and material weaknesses. If there are significant deficiencies that, individually or in combination, result in one or more material weaknesses, management is precluded from concluding that internal control over financial reporting is effective. In these circumstances, the auditor must express an adverse opinion on the company's internal control over financial reporting.

163. When expressing an adverse opinion because of a material weakness, the auditor's report must include:

- The definition of a material weakness and a significant deficiency, as provided in paragraphs 8 and 9.

- A statement that a material weakness has been identified and included in management's assessment. (If the material weakness has not been included in management's assessment, this sentence should be modified to state that the material weakness has been identified but not included in management's assessment. In this case, the auditor also is required to communicate to the audit committee that the material weakness was not disclosed or identified as a material weakness in management's report, as discussed in paragraph 190.)

- A description of any material weaknesses identified in a company's internal control over financial reporting. This description should provide the users of the audit report with specific information about the nature of any material weakness, and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness. This description also should address requirements described in paragraph 178.

164. In addition, the auditor should modify the opinion paragraph to express an adverse opinion directly on the effectiveness of the company's internal control over financial reporting. Example A-2 in Appendix A illustrates the form of the report that is appropriate in this situation.

165. *Scope Limitations.* The auditor can express an unqualified opinion on internal control over financial reporting only if the auditor has been able to apply all the procedures necessary under the circumstances. If there are restrictions on the scope of the engagement imposed by the circumstances, the auditor should withdraw from the engagement, disclaim an opinion, or express a qualified opinion. The auditor's decision depends on his or her assessment of the importance of the omitted procedure(s) to his or her ability to form an opinion on the effectiveness of the company's internal control over financial reporting. However, when the restrictions are imposed by management, the auditor should withdraw from the engagement or disclaim an opinion on the effectiveness of internal control over financial reporting.

166. For example, management might have identified a material weakness in its internal control over financial reporting prior to the date specified in its report and implemented controls to correct it. If management believes that the new controls have been operating for a sufficient period of time to determine that they are both effectively designed and operating, management would be able to include in its assessment its

conclusion that internal control over financial reporting is effective as of the date specified. However, if the auditor disagrees with the sufficiency of the time period, he or she would be unable to obtain sufficient evidence that the new controls have been operating effectively for a sufficient period. In that case, the auditor should modify the opinion because of a scope limitation.

167. When the auditor plans either to issue a qualified opinion or to disclaim an opinion because of a scope limitation, the auditor should report directly on the effectiveness of internal control over financial reporting (rather than on management's assessment) to best communicate the effect of such factors on his or her opinion. Example A-3 in Appendix A illustrates the form of report when there is a limitation on the scope of the audit causing the auditor to issue a qualified opinion. Example A-4 illustrates the form of report when restrictions on the scope of the audit cause the auditor to disclaim an opinion.

168. *Opinion Based in Part on the Report of Another Auditor.* When another auditor has audited internal control over financial reporting of one or more subsidiaries, divisions, branches, or components of the company, the auditor should determine whether he or she may serve as the principal auditor and use the work and reports of another auditor as a basis, in part, for his or her opinion on internal control over financial reporting. If the auditor decides it is appropriate to serve as the principal auditor, he or she should decide whether to make reference in the report to the audit performed by the other auditor. In these circumstances, the auditor's criteria are similar to those of the independent auditor who uses the work and reports of other independent auditors when reporting on a company's financial statements. AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, provides direction on the auditor's decision of whether to serve as the principal auditor and, if so, whether to make reference to the audit performed by the other auditor.

169. When the auditor decides to make reference to the report of the other auditor as a basis, in part, for his or her opinion, the auditor should disclose this when describing the scope of the audit and should refer to the report of the other auditor when expressing the opinion. Whether the other auditor's opinion is expressed on management's assessment or on the effectiveness of internal control over financial reporting does not affect the determination of whether the principal auditor's opinion is expressed on the assessment or on the subject matter itself.

170. *Subsequent Events.* Changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting might occur subsequent to the date as of which internal control over financial reporting is being audited but before the date of the auditor's report. As described in paragraph 128, the auditor should obtain written representations from management relating to such

matters. Additionally, to obtain information about whether changes have occurred that might affect the effectiveness of the company's internal control over financial reporting and, therefore, the auditor's report, the auditor should inquire about and examine, for this subsequent period, the following:

- Relevant internal audit reports (or similar functions, such as loan review in a financial institution) issued during the subsequent period,

- Independent auditor reports (if other than the auditor's) of significant deficiencies or material weaknesses,

- Regulatory agency reports on the company's internal control over financial reporting, and

- Information about the effectiveness of the company's internal control over financial reporting obtained through other engagements.

171. The auditor could inquire about and examine other documents for the subsequent period. Paragraphs .01 through .09 of AU sec. 560, *Subsequent Events,* provides direction on subsequent events for a financial statement audit that may also be helpful to the auditor performing an audit of internal control over financial reporting.

172. If the auditor obtains knowledge about subsequent events that materially and adversely affect the effectiveness of the company's internal control over financial reporting as of the date specified in the assessment the auditor should issue an adverse opinion. If the auditor is unable to determine the effect of the subsequent event on the effectiveness of the company's internal control over financial reporting, the auditor should disclaim an opinion. As described in paragraph 175, the auditor should disclaim an opinion on management's disclosures about corrective actions taken by the company after the date of management's assessment, if any.

173. The auditor may obtain knowledge about subsequent events with respect to conditions that did not exist at the date specified in the assessment but arose subsequent to that date. If a subsequent event of this type has a material effect on the company, the auditor should include in his or her report an explanatory paragraph describing the event and its effects or directing the reader's attention to the event and its effects as disclosed in management's report. Management's consideration of such events to be disclosed in its report should be limited to a change that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

174. *Management's Report Containing Additional Information.* Management's report on internal control over financial reporting may contain information in addition to

management's assessment of the effectiveness of its internal control over financial reporting. Such information might include, for example:

- Disclosures about corrective actions taken by the company after the date of management's assessment,
- The company's plans to implement new controls, and
- A statement that management believes the cost of correcting a material weakness would exceed the benefits to be derived from implementing new controls.

175. If management's assessment includes such additional information, the auditor should disclaim an opinion on the information. For example, the auditor should use the following language as the last paragraph of the report to disclaim an opinion on management's cost-benefit statement:

> We do not express an opinion or any other form of assurance on management's statement referring to the costs and related benefits of implementing new controls.

176. If the auditor believes that management's additional information contains a material misstatement of fact, he or she should discuss the matter with management. If the auditor concludes that there is a valid basis for concern, he or she should propose that management consult with some other party whose advice might be useful, such as the company's legal counsel. If, after discussing the matter with management and those management has consulted, the auditor concludes that a material misstatement of fact remains, the auditor should notify management and the audit committee, in writing, of the auditor's views concerning the information. The auditor also should consider consulting the auditor's legal counsel about further actions to be taken, including the auditor's responsibility under Section 10A of the Securities Exchange Act of 1934.

177. *Effect of Auditor's Adverse Opinion on Internal Control Over Financial Reporting on the Opinion on Financial Statements.* In some cases, the auditor's report on internal control over financial reporting might describe a material weakness that resulted in an adverse opinion on the effectiveness of internal control over financial reporting while the audit report on the financial statements remains unqualified. Consequently, during the audit of the financial statements, the auditor did not rely on that control. However, he or she performed additional substantive procedures to determine whether there was a material misstatement in the account related to the control. If, as a result of these procedures, the auditor determines that there was not a material misstatement in the account, he or she would be able to express an unqualified opinion on the financial statements.

178. When the auditor's opinion on the financial statements is unaffected by the adverse opinion on the effectiveness of internal control over financial reporting, the report on internal control over financial reporting (or the combined report, if a combined report is issued) should include the following or similar language in the paragraph that describes the material weakness:

> This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 20X3 financial statements, and this report does not affect our report dated [*date of report*] on those financial statements. *[Revise this wording appropriately for use in a combined report.]*

179. Such disclosure is important to ensure that users of the auditor's report on the financial statements understand why the auditor issued an unqualified opinion on those statements.

180. *Subsequent Discovery of Information Existing at the Date of the Auditor's Report on Internal Control Over Financial Reporting*. After the issuance of the report on internal control over financial reporting, the auditor may become aware of conditions that existed at the report date that might have affected the auditor's opinion had he or she been aware of them. The auditor's evaluation of such subsequent information is similar to the auditor's evaluation of information discovered subsequent to the date of the report on an audit of financial statements, as described in AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*. That standard requires the auditor to determine whether the information is reliable and whether the facts existed at the date of his or her report. If so, the auditor should determine (1) whether the facts would have changed the report if he or she had been aware of them and (2) whether there are persons currently relying on or likely to rely on the auditor's report. For instance, if previously issued financial statements and the auditor's report have been recalled and reissued to reflect the correction of an error, the auditor should presume that his or her report on the company's internal control over financial reporting as of same specified date also should be recalled and reissued to reflect the material weakness that existed at that date. Based on these considerations, AU sec. 561.06 provides detailed requirements for the auditor.

181. *Filings Under Federal Securities Statutes.* AU sec. 711, *Filings Under Federal Securities Statutes,* describes the auditor's responsibilities when an auditor's report is included in registration statements, proxy statements, or periodic reports filed under the federal securities statutes. The auditor should also apply AU sec. 711 with respect to the auditor's report on management's assessment of the effectiveness of internal control over financial reporting included in such filings. In addition, the direction in AU sec. 711.10 to inquire of and obtain written representations from officers and other

executives responsible for financial and accounting matters about whether any events have occurred that have a material effect on the audited financial statements should be extended to matters that could have a material effect on management's assessment of internal control over financial reporting.

182. When the auditor has fulfilled these responsibilities and intends to consent to the inclusion of his or her report on management's assessment of the effectiveness of internal control over financial reporting in the securities filing, the auditor's consent should clearly indicate that both the audit report on financial statements and the audit report on management's assessment of the effectiveness of internal control over financial reporting (or both opinions if a combined report is issued) are included in his or her consent.

Auditor's Responsibilities for Evaluating Management's Certification Disclosures About Internal Control Over Financial Reporting

Required Management Certifications

183. Section 302 of the Act, as amended, requires a company's management, with the participation of the principal executive and financial officers (the certifying officers), to make the following quarterly and annual certifications with respect to the company's internal control over financial reporting:

- A statement that the certifying officers are responsible for establishing and maintaining internal control over financial reporting,
- A statement that the certifying officers have designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under their supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles, and
- A statement that the report discloses any changes in the company's internal control over financial reporting that occurred during the most recent fiscal quarter (the company's fourth fiscal quarter in the case of an annual report) that have materially affected, or are reasonably likely to materially affect, the company's internal control over financial reporting.

184. When the reason for a change in internal control over financial reporting is the correction of a material weakness, management and the auditor need to evaluate

whether the reason for the change and the circumstances surrounding that change are material information necessary to make the disclosure about the change not misleading.[23]

Auditor Evaluation Responsibilities

185. The auditor's responsibility as it relates to management's quarterly certifications on internal control over financial reporting is different from the auditor's responsibility as it relates to management's annual assessment of internal control over financial reporting. The auditor should perform limited procedures quarterly to provide a basis for determining whether he or she has become aware of any material modifications that, in the auditor's judgment, should be made to the disclosures about changes in internal control over financial reporting in order for the certifications to be accurate and to comply with the requirements of Section 302.

186. To fulfill this responsibility, the auditor should perform, on a quarterly basis, the following procedures:

- Inquire of management about significant changes in the design or operation of internal control over financial reporting as it relates to the preparation of annual as well as interim financial information that could have occurred subsequent to the preceding annual audit or prior review of interim financial information, and

- Determine, through a combination of observation and inquiry, whether significant changes in internal control over financial reporting may introduce significant deficiencies or material weaknesses in the design of internal control over financial reporting.

187. When matters come to auditor's attention that lead him or her to believe that modification to the disclosures about changes in internal control over financial reporting are necessary for the certifications to be accurate and to comply with the requirements

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[23] The SEC's Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities and Exchange Commission Release No. 33-8238 (June 5, 2003) [68 FR 36636], states: "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."

of Section 302, the auditor should communicate the matter(s) to the appropriate level of management as soon as practicable.

188. If, in the auditor's judgment, management does not respond appropriately to the auditor's communication within a reasonable period of time, the auditor should inform the audit committee. If, in the auditor's judgment, the audit committee does not respond appropriately to the auditor's communication within a reasonable period of time, the auditor should evaluate whether to resign from the engagement. The auditor should evaluate whether to consult with his or her attorney when making these evaluations. In these circumstances, the auditor also has responsibilities under AU sec. 317, *Illegal Acts by Clients,* and Section 10A of the Securities Exchange Act of 1934. The auditor's responsibilities for evaluating the disclosures about changes in internal control over financial reporting do not diminish in any way management's responsibility for ensuring that their certifications comply with the requirements of Section 302.

189. If matters come to the auditor's attention as a result of the audit of internal control over financial reporting that lead him or her to believe that modification to the disclosures about changes in internal control over financial reporting (addressing changes in internal control over financial reporting occurring during the fourth quarter) are necessary for the annual certifications to be accurate and to comply with the requirements of Section 302, the auditor should follow the same communication responsibilities as described in paragraphs 187 and 188. However, if management and the audit committee do not respond appropriately, in addition to the responsibilities described in the preceding two paragraphs, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons the auditor believes management's certification should be modified.

Required Communications in An Audit of Internal Control Over Financial Reporting

190. The auditor must communicate in writing to the audit committee all significant deficiencies and material weaknesses identified during the audit. The written communication should be made prior to the issuance of the auditor's report on internal control over financial reporting. The auditor's communication should distinguish clearly between those matters considered significant deficiencies and those considered material weaknesses, as defined beginning in paragraph 8.

191. In addition, the auditor should communicate to management, in writing, all deficiencies in internal control over financial reporting (that is, those deficiencies in internal control over financial reporting that are of a lesser magnitude than significant deficiencies) identified during the audit and inform the audit committee when such a

communication has been made. When making this communication, it is not necessary for the auditor to repeat information about such deficiencies that have been included in previously issued written communications, whether those communications were made by the auditor, internal auditors, or others within the organization. Rather, the auditor may incorporate those deficiencies by referring to the title and date of such reports. Furthermore, the auditor is not required to perform procedures sufficient to identify all internal control deficiencies; rather, the auditor should communicate deficiencies in internal control over financial reporting of which he or she is aware.

192. When auditing internal control over financial reporting, the auditor may become aware of fraud or possible illegal acts. If the matter involves fraud, it must be brought to the attention of the appropriate level of management. If the fraud involves senior management, the auditor must communicate the matter directly to the audit committee as described in AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*. If the matter involves possible illegal acts, the auditor must assure himself or herself that the audit committee is adequately informed, unless the matter is clearly inconsequential, in accordance with AU sec. 317, *Illegal Acts by Clients*. The auditor also must determine his or her responsibilities under Section 10A of the Securities Exchange Act of 1934.

193. When timely communication is important, the auditor should communicate the preceding matters during the course of the audit rather than at the end of the engagement. The decision about whether an interim communication should be issued should be determined based on the relative significance of the matters noted and the urgency of corrective follow-up action required.

Effective Date

194. Companies considered *accelerated filers* under Exchange Act Rule 12b-2 are required to comply with the internal control reporting and disclosure requirements of Section 404 of the Act *for fiscal years ending on or after June 15, 2004*. (Other companies have until fiscal years ending on or after April 15, 2005, to comply with these internal control reporting and disclosure requirements.) Accordingly, independent auditors engaged to audit the financial statements of accelerated filers for fiscal years ending on or after June 15, 2004, also are required to audit and report on the company's internal control over financial reporting as of the end of such fiscal year. This standard is required to be complied with for such engagements.

195. Early compliance with this standard is permitted.

APPENDIX A

Illustrative Reports on Internal Control Over Financial Reporting

A.1 Paragraphs 152 through 179 of this standard provide direction on the auditor's report on management's assessment of internal control over financial reporting. The following examples illustrate how to apply that guidance in several different situations.

Example A-1

ILLUSTRATIVE REPORT EXPRESSING AN UNQUALIFIED OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING (SEPARATE REPORT)[1]

<u>Independent Auditor's Report</u>

[*Introductory paragraph*]

We have audited management's assessment, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify criteria,* f*or example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for its assessment about the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment based on our audit.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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[1] If the auditor issues separate reports on the audit of internal control and the audit of the financial statements, both reports should include a statement that the audit was conducted in accordance with auditing and related professional practice standards established by the Public Company Accounting Oversight Board.

[*Scope paragraph*]

We conducted our audit in accordance with auditing and related professional practice standards established by the Public Company Accounting Oversight Board. Those standards require that we plan and perform our audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, management's assessment that W Company maintained effective internal control over financial reporting as of December 31, 20X3, is fairly stated, in all material respects, based on [*Identify criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[Signature]

[*Date*]

Example A-2

ILLUSTRATIVE REPORT EXPRESSING AN ADVERSE OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING BECAUSE OF THE EXISTENCE OF A MATERIAL WEAKNESS

Independent Auditor's Report

[*Introductory paragraph*]

We have audited management's assessment included in the accompanying [*title of management's report*] that W Company did not maintain effective internal control over financial reporting as of December 31, 20X3, because of the effect of [*material weakness identified in management's assessment*], based on [*Identify criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for its assessment about the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment based on our audit.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Scope paragraph*]

We conducted our audit in accordance with auditing and related professional practice standards established by the Public Company Accounting Oversight Board. Those standards require that we plan and perform our audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Explanatory paragraph*]

A material weakness is a significant deficiency that, by itself, or in combination with other significant deficiencies, results in more than a remote likelihood of a material misstatement of the annual or interim financial statements. A significant deficiency is an internal control deficiency that adversely affects the company's ability to initiate, record, process, and report external financial data reliably in accordance with generally accepted accounting principles. The following material weakness has been identified and included in management's assessment.[1] [*Include a description of the material weakness and its effect on the achievement of the objectives of the control criteria.*] This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 20X3 financial statements, and this report does not affect our report dated [*date of report, which should be the same as the date of this report on internal control*] on those financial statements.

[1] If the auditor has identified a material weakness that is not included in management's assessment, add the following wording to the report: "In addition, we have identified the following material weakness that has not been identified as a material weakness in management's assessment. *[Include a description of the material weakness and its effect on the achievement of the objectives of the control criteria.]*"

[*Opinion paragraph*]

In our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, W Company has not maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Signature*]

[*Date*]

Example A-3

ILLUSTRATIVE REPORT EXPRESSING A QUALIFIED OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING BECAUSE OF A LIMITATION ON THE SCOPE OF THE AUDIT

<u>Independent Auditor's Report</u>

[*Introductory paragraph*]

We have audited management's assessment included in the accompanying [*title of management's report*] that W Company maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for its assessment about the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment based on our audit.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Scope paragraph*]

Except as described below, we conducted our audit in accordance with auditing and related professional practice standards established by the Public Company Accounting Oversight Board. Those standards require that we plan and perform our audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

[*Explanatory paragraph that describes scope limitation*]

A *material weakness* is a significant deficiency that, by itself, or in combination with other significant deficiencies, results in more than a remote likelihood of a material misstatement of the annual or interim financial statements. A *significant deficiency* is an internal control deficiency that adversely affects the company's ability to initiate, record, process, and report external financial data reliably in accordance with generally accepted accounting principles. The following material weakness has been identified and included in management's assessment.[1] Prior to December 20, 20X3, W Company had an inadequate system for recording cash receipts, which could have prevented the Company from recording cash receipts on accounts receivable completely and properly. Therefore, cash received could have been diverted for unauthorized use, lost, or otherwise not properly recorded to accounts receivable. We believe this condition was a material weakness in the design or operation of the internal control of W Company in effect prior to December 20, 20X3. Although the Company implemented a new cash receipts system on December 20, 20X3, the system has not been in operation for a sufficient period of time to enable us to obtain sufficient evidence about its operating effectiveness.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of

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[1] If the auditor has identified a material weakness that is not included in management's assessment, add the following wording to the report: "In addition, we have identified the following material weakness that has not been identified as a material weakness in management's assessment. *[Include a description of the material weakness and its effect on the achievement of the objectives of the control criteria.]*"

changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, except for the effect of matters we might have discovered had we been able to examine evidence about the effectiveness of the new cash receipts system, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X3, based on [*Identify criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Signature*]

[*Date*]

Example A-4

ILLUSTRATIVE REPORT DISCLAIMING AN OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING BECAUSE OF A LIMITATION ON THE SCOPE OF THE AUDIT

<u>Independent Auditor's Report</u>

[*Introductory paragraph*]

We were engaged to audit management's assessment included in the accompanying [*title of management's report*] that W Company maintained effective internal control over financial reporting as of December 31, 20X3 based on [*Identify criteria,* f*or example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for maintaining effective internal control over financial reporting.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Omit scope paragraph*]

[*Explanatory paragraph that describes scope limitation*]

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

Since management [*describe scope restrictions*] and we were unable to apply other procedures to satisfy ourselves as to the company's internal control over financial reporting, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the effectiveness of the company's internal control over financial reporting.

[*Signature*]

[*Date*]

Example A-5

ILLUSTRATIVE REPORT EXPRESSING AN UNQUALIFIED OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING THAT REFERS TO THE REPORT OF OTHER AUDITORS AS A BASIS, IN PART, FOR THE AUDITOR'S OPINION

Independent Auditor's Report

[*Introductory paragraph*]

We have audited management's assessment that W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X3, based on [*Identify criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for maintaining effective internal control over financial reporting. Our responsibility is to express an opinion on management's assessment based on our audit. We did not examine the effectiveness of internal control over financial reporting of B Company, a wholly owned subsidiary, whose financial statements reflect total assets and revenues constituting 20 and 30 percent, respectively of the related consolidated financial statement amounts as of and for the year ended December 31, 20XX. The effectiveness of B Company's internal control over financial reporting was audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the effectiveness of B Company's internal control over financial reporting, is based solely on the report of the other auditors.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Scope paragraph*]

We conducted our audit in accordance with auditing and related professional practice standards established by the Public Company Accounting Oversight Board. Those standards require that we plan and perform our audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit and the report of the other auditors provide a reasonable basis for our opinion.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, based on our audit and the report of the other auditors, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X3, based on [*Identify criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Signature*]

[*Date*]

Example A-6

ILLUSTRATIVE COMBINED REPORT EXPRESSING AN UNQUALIFIED OPINION ON FINANCIAL STATEMENTS AND AN UNQUALIFIED OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING

<u>Independent Auditor's Report</u>

[*Introductory paragraph*]

We have audited the accompanying balance sheets of W Company as of December 31, 20X3 and 20X2, and the related statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 20X3. We also have audited management's assessment, included in the accompanying [*identify title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for these financial statements and for the assessment about the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these financial statements and on management's assessment based on our audits.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Scope paragraph*]

We conducted our audits in accordance with auditing and related professional practice standards established by the Public Company Accounting Oversight Board. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. An audit of internal control includes obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of W Company as of December 31, 20X3 and 20X2, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 20X3 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, management's assessment that W Company maintained effective internal control over financial reporting as of December 31, 20X3, is fairly stated, in all material respects, based on [*Identify criteria,* for *example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Signature*]

[*Date*]

APPENDIX B

Additional Performance Requirements and Guidance; Extent of Testing Examples

Tests to be Performed When a Company Has Multiple Locations or Business Units

B1. To determine the locations or business units for performing audit procedures, the auditor should evaluate their relative financial significance and the risk of material misstatement arising from them. In making this evaluation, the auditor should identify the locations or business units that are individually important, evaluate their documentation of controls, and test controls over significant accounts and disclosures. For locations or business units that contain specific risks that, by themselves, could create a material misstatement, the auditor should evaluate the documentation of controls and test controls over the specific risks.

B2. The auditor should determine which other locations or business units, when aggregated, represent a group with a level of financial significance that could create a material misstatement in the financial statements. For that group, the auditor should determine whether there are company-level controls in place. If so, the auditor should evaluate the documentation and test such company-level controls. If not, the auditor should perform tests of controls at some of the locations or business units.

B3. No further work is necessary on the remaining locations and businesses, provided that they are not able to create, either individually or in the aggregate, a material misstatement in the financial statements.

Locations or Business Units That are Financially Significant

B4. Because of the importance of financially significant locations, the auditor should evaluate management's documentation of and perform tests of controls over all relevant assertions related to significant accounts and disclosures at each financially significant location or business unit, as discussed in paragraphs 84 through 110. Generally, a relatively small number of locations or business units will encompass a large portion of a company's operations and financial position, making them financially significant.

B5. In determining the nature, timing, and extent of testing at the individual locations or business units, the auditor should evaluate each entity's involvement, if any, with a central processing or shared service environment.

Locations or Business Units That Involve Specific Risks

B6. Although a location or business unit might not be individually financially significant, it might present specific risks that, by themselves, could create a material misstatement in the company's financial statements. The auditor should test the controls over the specific risks that could create a material misstatement in the company's financial statements. The auditor need not test controls over all relevant assertions for all significant accounts at these locations or business units. For example, a business unit responsible for foreign exchange trading could expose the company to the risk of material misstatement, even though the relative financial significance of such transactions is low.

Locations or Business Units That are Significant Only When Aggregated with Other Locations and Business Units

B7. In determining the nature, timing, and extent of testing, the auditor should determine whether management has documented and placed in operation company-level controls (see paragraph 53) over individually unimportant locations and business units that, when aggregated with other locations or business units, might have a high level of financial significance. Such a level of financial significance could create a greater than remote risk of material misstatement of the financial statements.

B8. For the purposes of this evaluation, company-level controls are controls management has in place to monitor the operations and to oversee the control environment and risk assessment process at these locations or business units.

B9. The auditor should perform tests of company-level controls to determine whether such controls are operating effectively. The auditor might conclude that he or she cannot evaluate the operating effectiveness of such controls without visiting some or all of the locations or business units.

B10. If management does not have company-level controls operating at these locations and business units, the auditor should determine the nature, timing, and extent of procedures to be performed at each location, business unit, or combination of locations and business units. When determining the locations or business units to visit and the controls to test, the auditor should evaluate the following factors:

- The relative financial significance of each location or business unit.

- The risk of material misstatement arising from each location or business unit.

- The similarity of business operations and internal control over financial reporting at the various locations or business units.

- The degree of centralization of processes and financial reporting applications.

- The effectiveness of the control environment, particularly management's direct control over the exercise of authority delegated to others and its ability to effectively supervise activities at the various locations or business units. An ineffective control environment over the locations or business units might constitute a material weakness.

- The nature and amount of transactions executed and related assets at the various locations or business units.

- The potential for material unrecognized obligations to exist at a location or business unit and to what degree the location or business unit could create an obligation on the part of the company.

- Management's risk assessment process and analysis for excluding a location or business unit from its assessment of internal control over financial reporting.

B11. Testing company-level controls is not a substitute for the auditor's testing of controls over a large portion of the company's operations or financial position. If the auditor cannot test a large portion of the company's operations and financial position by selecting a relatively small number of locations or business units, he or she should expand the number of locations or business units selected to evaluate internal control over financial reporting.

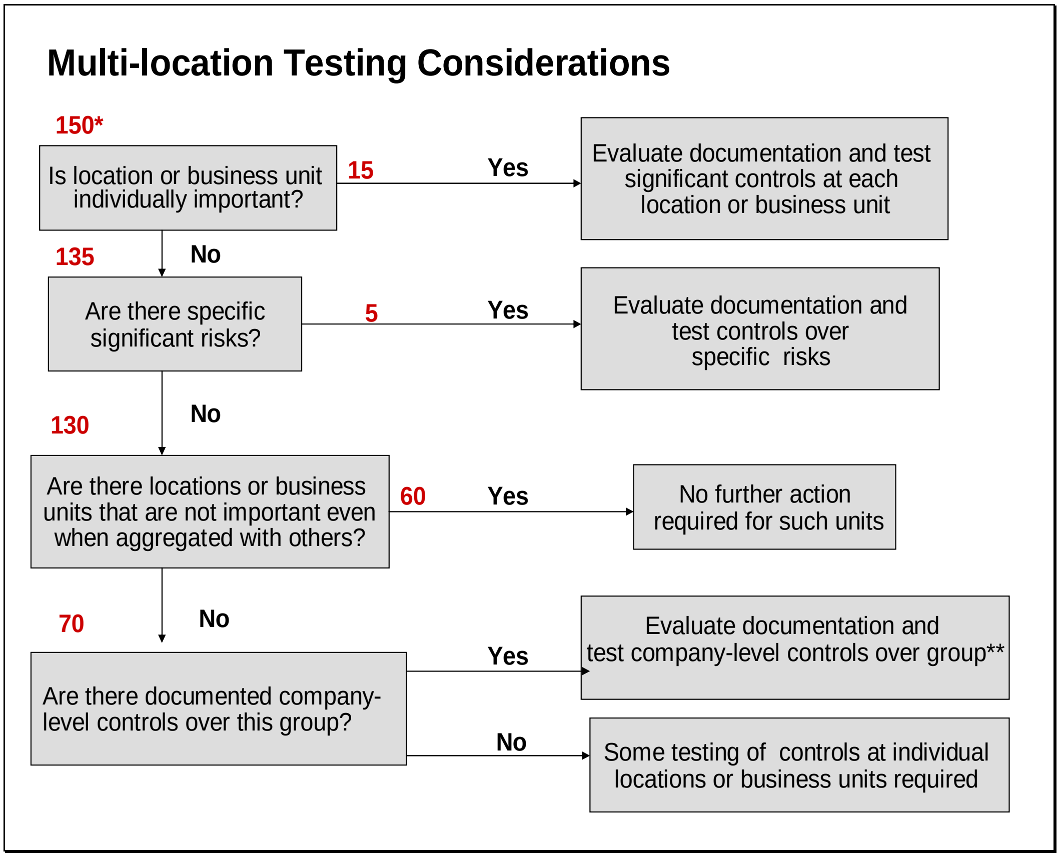
Locations and Business Units That Do Not Require Testing

B12. No testing is required with respect to locations or business units that individually, and when aggregated with others, could not result in a material misstatement to the financial statements.

Multi-Location Testing Considerations Flowchart

B13. Illustration B-1 depicts how to apply the directions in this section to a hypothetical company with 150 locations or business units, along with the auditor's testing considerations for those locations or business units.

Illustration B-1



* Numbers represent number of locations affected.

** See paragraph B7.

Special Situations

B14. The scope of the evaluation of the company's internal control over financial reporting should include entities that are acquired on or before the date of management's assessment and operations that are accounted for as discontinued operations on the date of management's assessment. The auditor should consider this multiple locations discussion in determining whether it will be necessary to test controls at these entities or operations.

B15. For equity method investments, the evaluation of the company's internal control over financial reporting should include controls over the reporting in accordance with generally accepted accounting principles, in the company's financial statements, of the company's portion of the investees' income or loss, the investment balance, adjustments to the income or loss and investment balance, and related disclosures. The evaluation ordinarily would not extend to controls at the equity method investee.

B16. For entities that are consolidated or proportionately consolidated, the evaluation of the company's internal control over financial reporting should include controls over significant accounts and processes that exist at the consolidated or proportionately consolidated entity. In some instances, however, such as for some variable interest entities as defined in Financial Accounting Standards Board Interpretation No. 46, *Consolidation of Variable Interest Entities,* management might not have the ability to obtain the information necessary to make an assessment because it does not have the ability to control the entity. If management is allowed to limit its assessment by excluding such entities,[1] the auditor may limit the audit in the same manner, and report without reference to the limitation in scope. However, the auditor should evaluate the reasonableness of management's conclusion that they do not have the ability to obtain the necessary information as well as the appropriateness of any required disclosure related to such a limitation. If the auditor believes that management's disclosure about the limitation requires modification, the auditor should follow the same communication responsibilities as described in paragraphs 187 and 188. If management and the audit committee do not respond appropriately, in addition to fulfilling those responsibilities, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons the auditor believes management's disclosure should be modified.

Identifying Significant Accounts

B17. When deciding whether an account is significant, it is important for the auditor to evaluate both quantitative and qualitative factors, including the:

- Size and composition of the account,

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[1] It is our understanding that the SEC Staff may conclude that management can limit the scope of its assessment if it does not have the authority to affect, and therefore cannot assess, the controls in place over certain amounts. This would relate to entities that are consolidated or proportionately consolidated when the issuer does not have sufficient control over the entity to assess and affect controls. If management's report on its assessment of the effectiveness of internal control over financial reporting is limited in that manner, the SEC staff may permit the company to disclose this fact as well as information about the magnitude of the amounts included in the financial statements from entities whose controls cannot be assessed. This disclosure would be required in each filing, but outside of management's report on its assessment of the effectiveness of internal control over financial reporting.

- Susceptibility of loss due to errors or fraud,

- Volume of activity, complexity, and homogeneity of the individual transactions processed through the account,

- Nature of the account (for example, suspense accounts generally warrant greater attention),

- Accounting and reporting complexities associated with the account,

- Exposure to losses represented by the account (for example, loss reserves related to a consolidated captive insurance company),

- Likelihood (or possibility) of significant contingent liabilities arising from the activities represented by the account,

- Existence of related party transactions in the account, and

- Changes from the prior period in account characteristics (for example, new complexities or subjectivity or new types of transactions).

B18. For example, in a financial statement audit, the auditor might not consider the fixed asset accounts significant when there is a low volume of transactions and inherent risk is assessed as low, even though the balances are material to the financial statements. Accordingly, he or she might decide to perform only substantive tests on such balances. In an audit of internal control over financial reporting, however, such accounts are significant accounts because of their materiality to the financial statements.

B19. As another example, the auditor of the financial statements of a financial institution might not consider trust accounts significant to the institution's financial statements because such accounts are not included in the institution's balance sheet and the associated fee income generated by trust activities is not material. However, in determining whether trust accounts are a significant account for purposes of the audit of internal control over financial reporting, the auditor should assess whether the activities of the trust department are significant to the institution's financial reporting, which also would include considering the contingent liabilities that could arise if a trust department failed to fulfill its fiduciary responsibilities (for example, if investments were made that were not in accordance with stated investment policies). When assessing the significance of possible contingent liabilities, consideration of the amount of assets under the trust department's control may be useful. For this reason, an auditor who has not previously considered trust accounts significant accounts for purposes of the financial statement audit might determine that they are significant for purposes of the audit of internal control over financial reporting.

Using the Work of Others

Other Standards to Consider

B20. The auditor might find the directions in AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,* useful in assessing the competence and objectivity of internal auditors and others who have performed procedures as a basis for management's assessment.

Application Example

B21. The example included in the following paragraphs demonstrates how to apply the directions discussed in this section.

B22. In evaluating controls over the recording of revenue, the auditor needs to look at a variety of factors including, among other things, information technology general controls and controls over (1) determining the appropriate methods of revenue recognition under generally accepted accounting principles as it relates to the company's operations, (2) evaluating nonroutine sales transactions and contracts to determine the appropriate accounting and (3) the routine processing of daily sales through the company's accounting system.

- Because of the pervasive impact of the controls in (1) and the material impact those controls ordinarily have on the financial statements, the auditor should not use the results of testing by management and others within the company, as discussed in paragraph 104.

- The auditor should limit use of the results of testing performed by others within the company for the controls identified in (2), since the nonroutine nature of these transactions and contracts involve controls over decisions requiring considerable judgment.

- On the other hand, the auditor could increase the use of the results of testing by management and others relating to the controls in (3), which relate to the routine processing of daily sales transactions and accounts receivable. In that case, the auditor should follow the directions in paragraphs 106 through 109.

B23. In the situations described in (1) through (3) above, when evaluating whether sufficient evidence has been obtained, the auditor should understand that evidence obtained through his or her direct personal knowledge, observation, reperformance, and inspection is more persuasive than information obtained indirectly from others, such as from management, internal auditors, or other personnel. Furthermore, judgments about the sufficiency of evidence obtained and other factors affecting the auditor's opinion, such as the materiality of identified control deficiencies, should be those of the auditor.

Use of Service Auditor's Report

B24. When the company uses a service organization, the auditor, when planning the audit, should obtain an understanding of the portion of the company's internal control over financial reporting (that is, the initiating, recording, processing, and reporting of its transactions) performed at the service organization and the interaction of controls at the service organization with controls at the company.

B25. The use of a service organization does not reduce management's responsibility to maintain effective internal control over financial reporting. Rather, management should evaluate controls at the service organization, as well as related controls at the company, when making its assessment about internal control over financial reporting.

B26. The auditor should determine whether management has evaluated the activities of the service organization when making its assessment about internal control over financial reporting. For instance, a service organization is considered part of the company's internal control over financial reporting when it provides services that affect –

- How the company initiates its transactions,
- How the company's transactions are processed and reported in its accounting records, supporting information, and specific financial statement accounts,
- How the company's transactions are processed from the initiation of the transaction to its inclusion in the financial statements, or
- How the financial reporting process is used to prepare the client's financial statements.

B27. In addition, the auditor should evaluate the activities of the service organization in determining the nature, timing, and extent of evidence required to support his or her opinion on internal control over financial reporting. Paragraph .07 of AU sec. 324, *Service Organizations,* describes the procedures that management and the auditor should perform with respect to the activities performed by the service organization, which include:

- Obtaining an understanding of the controls at the service organization that are relevant to the company's internal control over financial reporting, and

- Obtaining evidence that the controls that are relevant to management's assessment and the auditor's opinion are operating effectively.

B28. A service organization might do several things to assist the auditor. For example, the service organization might:

- Engage its own auditor (service auditor) to review and report on the systems it uses to process the company's transactions.

- Engage a service auditor to test the effectiveness of the controls applied to the company's transactions to enable the auditor to evaluate controls at the service organization in an audit of internal control over financial reporting.

Auditor's Use of Service Auditor's Report

B29. 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. If so, the auditor should read the report for information that might be useful in planning the audit.

B30. A service auditor's *report on controls placed in operation,* as described in Paragraph .24a of AU sec. 324, expresses an opinion on a description of the controls at the service organization as of a specified date. The opinion indicates whether the controls described (a) were presented fairly in all material respects and (b) were suitably designed to provide reasonable assurance that the control objectives specified in the description would be achieved if complied with satisfactorily.

B31. A report on controls placed in operation might be helpful when planning the audit; however, it provides assurance only with respect to the control objectives specified in the description. Accordingly, there is no assurance that the specified objectives include all those that would be relevant to the company's internal control over financial reporting. Furthermore, if such a report contains a caveat that the stated control objectives might be achieved only if the company applies controls contemplated in the design of the system by the service organization, the auditor should evaluate whether the company is applying the necessary procedures. For example, completeness of processing payroll transactions might depend on the company's validation that all payroll records sent to the service center were processed by checking a control total. Finally, this type of report does not provide any evidence of the operating effectiveness of controls.

B32. If the auditor uses a service auditor's report when planning the audit, he or she should make inquiries concerning the service auditor's reputation, competence, and independence. In making those inquiries, the auditor should evaluate the relevance of the information in AU sec. 543, *Part of Audit Performed by Other Independent Auditors of Financial Statements.* The auditor also should read the report to determine whether it provides information the auditor needs, for example, by addressing the service organization's controls relevant to the assertions the auditor is testing. If the service auditor's report is not sufficient to meet the auditor's objectives, the auditor should gather the desired information from other sources, such as those discussed in the next section.

Unavailable Service Auditor's Report

B33. 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.
- The contract between the client and the service organization.
- Reports by internal auditors or regulatory authorities on the information system and other controls placed in operation by the service organization.
- Inquiries or observations of personnel at the company or at the service organization.

B34. In addition, the auditor's prior experience with the specific service organization might be helpful in planning the audit.

Report on Operating Effectiveness

B35. If the auditor believes that he or she also must obtain evidence about the operating effectiveness of service center controls, one way an auditor can obtain such evidence is by obtaining a service auditor's *report on controls placed in operation and tests of operating effectiveness,* as described in Paragraph .24b of AU sec. 324. This report provides a description of the tests of controls and results of those tests performed by the service auditor, as well as the service auditor's opinion on whether the controls that were tested were operating effectively during the specified period. If a service auditor's report on controls placed in operation and tests of operating effectiveness is available, management and the auditor should evaluate whether the report provides sufficient evidence to support their assessment and opinion, respectively. The evaluation should include the following factors:

- The time period covered by the service auditor's tests of controls in relationship to the date of management's assessment of internal control over financial reporting,
- The controls tested by the service auditor and how they relate to the company's controls,
- The results of the tests of controls performed by the service auditor, and
- The service auditor's opinion on the operating effectiveness of the controls.

B36. Such evaluations are similar to those the auditor would make when determining whether the service auditor's report provides sufficient evidence to support the auditor's assessed level of control risk in an audit of the financial statements, as described in Paragraph .16 of AU sec. 324. However, the auditor is responsible for evaluating the evidence provided by the service auditor's report and for determining its effect on the audit of internal control over financial reporting.

Inquiries About Changes in Controls

B37. When a significant period of time has elapsed between the time period covered by the service auditor's tests of controls and the date of management's assessment, the auditor should inquire of management about whether there have been changes in the service organization's controls subsequent to the period covered by the service auditor's report. Such changes might include:

- Changes communicated to management from the service organization,
- Changes in personnel, with whom management interacts, at the service organization,
- Changes in reports or other data received from the service organization,
- Changes in contracts or service level agreements with the service organization, or
- Errors identified in the service organization's processing.

B38. If management has informed the auditor of the types of changes noted in the preceding paragraph, the auditor should determine whether management has performed procedures to evaluate the effect of the changes on the effectiveness of the company's internal control over financial reporting. The auditor also should evaluate whether management was aware of changes in the service organization's controls that the auditor discovered while performing other procedures during the audit of internal control over financial reporting. In light of such evaluations, the auditor should determine whether there is a need for obtaining additional evidence about the operating effectiveness of controls at the service organization. If additional evidence is necessary, the auditor should:

- Reperform tests performed by management or others within the company,
- Contact the service organization, through the client, to obtain specific information,
- Request that a service auditor be engaged to perform procedures that will supply the necessary information, or
- Visit the service organization and perform procedures that will supply the necessary evidence.

B39. Because the auditor is responsible for obtaining sufficient evidence to support the opinion on internal control over financial reporting, he or she should not refer to the service auditor's report when expressing such an opinion.

Examples of Extent of Testing Decisions

B40. As discussed throughout this standard, determining the effectiveness of a company's internal control over financial reporting includes evaluating the design and operating effectiveness of controls over all relevant assertions related to all significant accounts and disclosures in the financial statements. Paragraphs 88 through 110 provide the auditor with directions about the nature, timing, and extent of testing of the operating effectiveness of internal control over financial reporting.

B41. Examples B-1 through B-4 illustrate how to apply this information in various situations. These examples are for illustrative purposes only.

Example B-1 – ***Daily Programmed Application Control and Daily Information Technology-Dependent Manual Control***

The auditor has determined that cash and accounts receivable are significant accounts to the audit of XYZ Company's internal control over financial reporting. Based on discussions with company personnel and review of company documentation, the auditor learned that the company had the following procedures in place to account for cash received in the lockbox:

a. The company receives a download of cash receipts from the banks.

b. The information technology system applies cash received in the lockbox to individual customer accounts.

c. Any cash received in the lockbox and not applied to a customer's account is listed on an exception report (Unapplied Cash Exception Report).

   — Therefore, the application of cash to a customer's account is a programmed application control, while the review and follow-up of unapplied cash from the exception report is a detective control.

To determine whether misstatements in cash (existence assertion) and accounts receivable (existence, valuation, and completeness) would be prevented or detected on a timely basis, the auditor decided to test the controls provided by the system in the daily reconciliation of lock box receipts to customer accounts, as well as the control over reviewing and resolving unapplied cash in the Unapplied Cash Exception Report.

Nature, Timing, and Extent of Procedures. To test the programmed application control, the auditor:

- Identified, through discussion with company personnel, the software used to receive the download from the banks and to process the transactions and determined that the banks supply the download software.

  — The company uses accounting software used from a third-party supplier. The software consists of a number of modules. The client modifies the software only for upgrades supplied by the supplier.

- Determined, through further discussion with company personnel, that the cash module operates the lockbox functionality and the posting of cash to the general ledger. The accounts receivable module posts the cash to individual customer accounts and produces the Unapplied Cash Exception Report, a standard report supplied with the package. The auditor agreed this information to the supplier's documentation.

- Identified, through discussions with company personnel and review of the supplier's documentation, the names, file sizes (in bytes), and locations of the executable files (programs) that operate the functionality under review. The auditor then found the compilation dates of these programs and agreed them to the original installation date of the application.

- Identified the objectives of the programs to be tested. The auditor wanted to determine whether only appropriate cash items are posted to customers' accounts and matched to customer number, invoice number, amount, etc., and that there is a listing of inappropriate cash items (that is, any of the above items not matching) on the exception report.

In addition, the auditor had evaluated and tested general computer controls, including program changes (for example, confirmation that no unauthorized changes are undertaken) and logical access (for example, data file access to the file downloaded from the banks and user access to the cash and accounts receivable modules) and concluded that they were operating effectively.

To determine whether such programmed controls were operating effectively, the auditor performed a walkthrough in the month of July. The computer controls operate in a systematic manner, therefore, the auditor concluded that it was sufficient to walkthrough only the one item. During the walkthrough, the auditor performed and documented the following items:

a. Selected one customer and agreed the amount billed to the customer to the cash received in the lockbox.

b. Agreed the total of the lockbox report to the posting of cash receipts in the general ledger.

c. Agreed the total of the cash receipt download from the bank to the lockbox report and supporting documentation.

d. Selected one customer's remittance and agreed amount posted to the customer's account in the accounts receivable subsidiary ledger.

To test the detect control of review and follow up on the Daily Unapplied Cash Exception Report, the auditor:

a. Made Inquiries of Company Personnel. To understand the procedures in place to ensure that all unapplied items are resolved, the time frame in which such resolution takes place, and whether unapplied items are handled properly within the system, the auditor discussed these matters with the employee responsible for reviewing and resolving the Daily Unapplied Cash Exception Reports. The auditor learned that when items appear on the Daily-Unapplied Cash Exception Report, the employee must manually enter the correction into the system. The employee typically performs the resolution procedures the next business day. Items that typically appear on the Daily Unapplied Cash Exception Report relate to payments made by a customer without reference to an invoice number/purchase order number or underpayments of an invoice due to quantity or pricing discrepancies.

b. Observed Personnel Performing the Control**.** The auditor then observed the employee reviewing and resolving a Daily Unapplied Cash Exception Report. The day selected contained four exceptions – three related to payments made by a customer without an invoice number, and one related to an underpayment due to a pricing discrepancy.

   – For the pricing discrepancy, the employee determined, through discussions with a sales person, that the customer had been billed an incorrect price; a price break that the sales person had granted to the customer was not reflected on the customer's invoice. The employee resolved the pricing discrepancy, determined which invoices were being paid, and entered a correction into the system to properly apply cash to the customer's account and reduce accounts receivable and sales accounts for the amount of the price break.

c. Reperformed the Control. Finally, the auditor selected 25 Daily Unapplied Cash Exception Reports from the period January to September. For the reports selected, the auditor reperformed the follow-up procedures that the employee performed. For instance, the auditor inspected the documents and sources of information used in the follow-up and determined that the transaction was properly corrected in the system. The auditor also scanned other Daily Unapplied Cash Exception Reports to determine that the control was performed throughout the period of intended reliance.

Because the tests of controls were performed at an interim date, the auditor had to determine whether there were any significant changes in the controls from interim to year-end. Therefore, the auditor asked company personnel about the procedures in place at year-end. Such procedures had not changed from the interim period, therefore, the auditor observed that the controls were still in place by scanning Daily Unapplied Cash Exception Reports to determine the control was performed on a timely basis during September to year-end.

Based on the auditor's procedures, the auditor concluded that the employee was clearing exceptions in a timely manner and that the control was operating effectively as of year-end.

Example B-2 – ***Monthly Manual Reconciliation***

The auditor determined that accounts receivable is a significant account to the audit of XYZ Company's internal control over financial reporting. Through discussions with company personnel and review of company documentation, the auditor learned that company personnel reconcile the accounts receivable subsidiary ledger to the general ledger on a monthly basis. To determine whether misstatements in accounts receivable (existence, valuation, and completeness) would be detected on a timely basis, the auditor decided to test the control provided by monthly reconciliation process.

Nature, Timing, and Extent of Procedures. The auditor tested the company's reconciliation control by selecting a sample of reconciliations based upon the number of accounts, the dollar value of the accounts, and the volume of transactions affecting the account. Because the auditor considered all other receivable accounts immaterial, and because such accounts had only minimal transactions flowing through them, the auditor decided to test only the reconciliation for the trade accounts receivable account. The auditor elected to perform the tests of controls over the reconciliation process in conjunction with the auditor's substantive tests over the accounts receivable confirmation procedures, which were performed in July.

To test the reconciliation process, the auditor:

- Made Inquiries of Personnel Performing the Control. The auditor asked the employee performing the reconciliation a number of questions, including the following:
  - What documentation describes the account reconciliation process?
  - How long have you been performing the reconciliation work?
  - What is the reconciliation process for resolving reconciling items?
  - How often are the reconciliations formally reviewed and signed off?
  - If significant issues or reconciliation problems are noticed, to whose attention do you bring them?
  - On average, how many reconciling items are there?
  - How are old reconciling items treated?
  - If need be, how is the system corrected for reconciling items?

- What is the general nature of these reconciling items?

- Observed the Employee Performing the Control**.** The auditor observed the employee performing the reconciliation procedures. For nonrecurring reconciling items, the auditor observed whether each item included a clear explanation as to its nature, the action that had been taken to resolve it, and whether it had been resolved on a timely basis.

- Reperformed the Control**.** Finally, the auditor inspected the reconciliations and reperfomed the reconciliation procedures. For the May and July reconciliations, the auditor traced the reconciling amounts to the source documents on a test basis. The only reconciling item that appeared on these reconciliations was cash received in the lockbox the previous day that had not been applied yet to the customer's account. The auditor pursued the items in each month's reconciliation to determine that the reconciling item cleared the following business day. The auditor also scanned through the file of all reconciliations prepared during the year and noted that they had been performed on a timely basis. To determine that the company had not made significant changes in its reconciliation control procedures from interim to year-end, the auditor made inquiries of company personnel and determined that such procedures had not changed from interim to year-end. Therefore, the auditor verified that controls were still in place by scanning the monthly account reconciliations to determine that the control was performed on a timely basis during the interim to year-end period.

Based on the auditor's procedures, the auditor concluded that the reconciliation control was operating effectively as of year-end.

Example B-3 – ***Daily Manual Prevent Control***

The auditor determined that cash and accounts payable were significant accounts to the audit of the company's internal control over financial reporting. Through discussions with company personnel, the auditor learned that company personnel make a cash disbursement only after they have matched the vendor invoice to the receiver and purchase order. To determine whether misstatements in cash (existence) and accounts payable (existence, valuation, and completeness) would be prevented on a timely basis, the auditor tested the control over making a cash disbursement only after matching the invoice with the receiver and purchase.

Nature, Timing, and Extent of Procedures. On a haphazard basis, the auditor selected 25 disbursements from the cash disbursement registers from January through September. In this example, the auditor deemed a test of 25 cash disbursement transactions an appropriate sample size because the auditor was testing a manual control performed as part of the routine processing of cash disbursement transactions through the system. Furthermore, the auditor expected no errors based on the results of company-level tests performed earlier. [If, however, the auditor had encountered a control exception, the auditor would have tested an additional number of items. If another control exception had been noted, the auditor would have decided (a) that this control was not effective and (b) to increase the extent of substantive tests to be performed in connection with the financial statement audit of the cash and accounts payable accounts.]

After obtaining the related voucher package, the auditor examined the invoice to see if it included the signature or initials of the accounts payable clerk, evidencing the clerk's performance of the matching control. However, a signature on a voucher package to indicate signor approval does not necessarily mean that the person carefully reviewed it before signing. The voucher package may have been signed based on only a cursory review (or without any review).

The auditor decided that the quality of the evidence regarding the effective operation of the control evidenced by a signature or initials was not sufficiently persuasive to ensure that the control operated effectively during the test period. In order to obtain additional evidence, the auditor reperformed the matching control corresponding to the signature, which included examining the invoice to determine that (a) its items matched to the receiver and purchase order and (b) it was mathematically accurate.

Because the auditor performed the tests of controls at an interim date, the auditor updated the testing through the end of the year (initial tests are through September to December) by asking the accounts payable clerk whether the control was still in place and operating effectively. The auditor confirmed that understanding by performing a walkthrough of one transaction in December.

Based on the auditor's procedures, the auditor concluded that the control over making a cash disbursement only after matching the invoice with the receiver and purchase was operating effectively as of year-end.

Example B-4 – ***Programmed Prevent Control and Weekly Information Technology-Dependent Manual Detect Control***

The auditor determined that cash, accounts payable, and inventory were significant accounts to the audit of the company's internal control over financial reporting. Through discussions with company personnel, the auditor learned that the company's computer system performs a three-way match of the receiver, purchase order, and invoice. If there are any exceptions, the system produces a list of unmatched items that is reviewed and followed up by employees on a weekly basis.

In this case, the computer match is a programmed application control, and the review and follow-up of the unmatched items report is a detect control. To determine whether misstatements in cash (existence) and accounts payable/inventory (existence, valuation, and completeness) would be prevented or detected on a timely basis, the auditor decided to test the programmed application control of matching the receiver, purchase order, and invoice as well as the review and follow-up control over unmatched items.

Nature, Timing, and Extent of Procedures. To test the programmed application control, the auditor:

- Identified, through discussion with company personnel, the software used to process receipts and purchase invoices. The software used was a third party package consisting of a number of modules.

- The auditor established through further discussion with company personnel that they do not modify the core functionality of the software, but sometimes make personalized changes to reports to meet the changing needs of the business. From previous experience with the company's information technology environment, the auditor believes that such changes are infrequent and that information technology process controls are well established.

- Established, through further discussion, that the inventory module operated the receiving functionality, including the matching of receipts to open purchase orders. Purchase invoices were processed in the accounts payable module, which matched them to an approved purchase order against which a valid receipt has been made. That module also produced the Unmatched Items Report, a standard report supplied with the package to which the company has not made any modifications. That information was agreed to the supplier's documentation and to documentation within the information technology department.

- Identified, through discussions with the client and review of the supplier's documentation, the names, file sizes (in bytes), and locations of the executable files (programs) that operate the functionality under review. The auditor then identified the compilation dates of the programs and agreed them to the original installation date of the application. The compilation date of the report code was agreed to documentation held within the information technology department relating to the last change made to that report (a change in formatting).

- Identified the objectives of the programs to be tested. The auditor wanted to determine whether appropriate items are received (for example, match a valid purchase order), appropriate purchase invoices are posted (for example, match a valid receipt and purchase order, non-duplicate reference numbers) and unmatched items (for example, receipts, orders or invoices) are listed on the exception report. The auditor then reperformed all those variations in the packages on a test-of-one basis to determine that the programs operated as described.

In addition, the auditor had evaluated and tested general computer controls, including program changes (for example, confirmation that no unauthorized changes are undertaken to the functionality and that changes to reports are appropriately authorized, tested, and approved before being applied) and logical access (for example, user access to the inventory and accounts payable modules and access to the area on the system where report code is maintained), and concluded that they were operating effectively. (Since the computer is deemed to operate in a systematic manner, the auditor concluded that it was sufficient to walkthrough only the one item.)

- To determine whether the programmed control was operating effectively, the auditor performed a walkthrough in the month of July. As a result of the walkthrough, the auditor performed and documented the following items:

  – Receiving cannot record the receipt of goods without matching the receipt to a purchase order on the system. The auditor tested that control by attempting to record the receipt of goods into the system without a purchase order. However, the system did not allow the auditor to do that. Rather, the system produced an error message stating that the goods could not be recorded as received without an active purchase order.

  – An invoice will not be paid unless the system can match the receipt and vendor invoice to an approved purchase order. The auditor tested that control by attempting to approve an invoice for payment in the system. The system did not allow the auditor to do that. Rather, it produced an error message indicating that invoices could not be paid without an active purchase order and receiver.

  – The system disallows the processing of invoices with identical vendor and identical invoice numbers. In addition, the system will not allow two invoices to be processed against the same purchase order unless the sum of the invoices is less than the amount approved on the purchase order. The auditor tested that control by attempting to process duplicate invoices. However, the system produced an error message indicating that the invoice had already been processed.

  – The system compares the invoice amounts to the purchase order. If there are differences in quantity/extended price, and such differences fall outside a pre-approved tolerance, the system does not allow the invoice to be processed. The auditor tested that control by attempting to process an invoice that had quantity/price differences outside the tolerance level of 10 pieces, or $1,000. The system produced an error message indicating that the invoice could not be processed because of such differences.

- The system processes payments only for vendors established in the vendor master file. The auditor tested that control by attempting to process an invoice for a vendor that was not established in the vendor master file. However, the system did not allow the payment to be processed.

- The auditor tested user access to the vendor file and whether such users can make modifications to such file by attempting to access and make changes to the vendor tables. However, the system did not allow the auditor to perform that function and produced an error message stating that the user was not authorized to perform that function.

- The auditor verified the completeness and accuracy of the Unmatched Items Report by verifying that one unmatched item was on the report and one matched item was not on the report.

To test the detect control of review and follow up on the Unmatched Items Report, the auditor performed the following procedures in the month of July for the period January to July:

- Made Inquiries of company personnel. To gain an understanding of the procedures in place to ensure that all unmatched items are followed-up properly and that corrections are made on a timely basis, the auditor made inquiries of the employee who follows up on the weekly-unmatched items reports. On a weekly basis, the control required the employee to review the Unmatched Items Report to determine why items appear on it. The employee's review includes proper follow-up on items, including determining whether:

  - All open purchase orders are either closed or voided within an acceptable amount of time.

  - The requesting party is notified periodically of the status of the purchase order and the reason for its current status.

  - The reason the purchase order remains open is due to incomplete shipment of goods and, if so, whether the vendor has been notified.

  - There are quantity problems that should be discussed with purchasing.

- Observed the Performance of the Control**.** The auditor observed the employee performing the control for the Unmatched Items Reports generated during the first week in July.

- Reperformance of the Control**.** The auditor selected five weekly Unmatched Items Reports, selected several items from each, and reperformed the procedures that the employee performed. The auditor also scanned other Unmatched Items Reports to determine that the control was performed throughout the period of intended reliance.

To determine that the company had not made significant changes in their controls from interim to year-end, the auditor discussed with company personnel the procedures in place for making such changes. Since the procedures had not changed from interim to year-end, the auditor observed that the controls were still in place by scanning the weekly Unmatched Items Reports to determine that the control was performed on a timely basis during the interim to year-end period.

Based on the auditor's procedures, the auditor concluded that the employee was clearing exceptions in a timely manner and that the control was operating effectively as of year-end.

APPENDIX C

Safeguarding of Assets

C1. *Safeguarding of assets* in a financial reporting context includes protection only against losses arising from intentional and unintentional misstatements in processing transactions and handling the related assets. Examples of unintentional misstatements include:

- Understatement of sales through failure to prepare invoices or through incorrect pricing or computation;
- Overpayments to vendors or employees arising from inaccuracies in quantities of materials or services, prices or rates, or computations;
- Physical loss or misappropriation of assets such as cash, securities, or inventory; and
- Improper allocation of certain costs, which would result in failure to recover these costs from customers.

C2. Examples of intentional misstatements include falsification of records for the purpose of causing improper computation of commissions, profit-sharing bonuses, royalties, and similar payments based on the recording of other transactions. Consequently, safeguarding controls over the use of a lockbox system for collecting cash and over access controls, such as passwords, that limit access to data and programs that process cash disbursements might both be relevant to an audit of internal control over financial reporting.

C3. The definition of *safeguarding of assets* used in this standard does not encompass the concept that one of management's primary functions is to protect the company's existing assets and acquire new ones. Thus, when evaluating whether the company's internal control over financial reporting is effective, the auditor is not required to understand and test controls over management's decision-making process for all sales and acquisitions. For example, management's decision to sell a product at a price that proves to be unprofitable might be regarded as a failure to protect existing assets. However, because that decision is outside the financial reporting process, it is not considered to be a deficiency in internal control over financial reporting. Likewise, decisions to incur expenditures for equipment that prove to be unnecessary or inefficient, for materials that prove to be unsatisfactory in production, for merchandise that proves to be unsaleable, for research that proves to be unproductive, for advertising that proves to be ineffective, and for similar management decisions are not deficiencies in a company's internal control over financial reporting because they are outside the scope of internal control over financial reporting.

APPENDIX D

Examples of Material Weaknesses and Significant Deficiencies

D1. Paragraph 7 of this standard defines an *internal control deficiency*. Paragraphs 8 and 9 go on to define a *significant deficiency* and a *material weakness*.

D2. Materiality in an audit of internal control over financial reporting is discussed in paragraphs 21-23, and paragraphs 116-126 provide additional direction on evaluating deficiencies in internal control over financial reporting.

D3. The following examples illustrate how to evaluate the significance of internal control deficiencies in various situations. These examples are for illustrative purposes only.

Example D-1**— *Reconciliations of Intercompany Accounts Are Not Performed on a Timely Basis***

Scenario A – Significant Deficiency. The company processes a significant number of routine intercompany transactions on a monthly basis. Individual intercompany transactions are not material and primarily relate to balance sheet activity, for example, cash transfers between business units to finance normal operations.

A formal management policy requires monthly reconciliation of intercompany accounts and confirmation of balances between business units. However, there is not a process in place to ensure performance of these procedures. As a result, detailed reconciliations of intercompany accounts are not performed on a timely basis. Management does perform monthly procedures to investigate selected large-dollar intercompany account differences. In addition, management prepares a detailed monthly variance analysis of operating expenses to assess their reasonableness.

Based only on these facts, the auditor should determine that this deficiency represents a significant deficiency for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be more than inconsequential, but less than material, because individual intercompany transactions are not material and the compensating controls operating monthly should detect a material misstatement. Furthermore, the transactions are primarily restricted to balance sheet accounts. However, the compensating detective controls are designed only to detect material misstatements. The controls do not address the detection of misstatements that are more than inconsequential but less than material. Therefore, the likelihood that a misstatement that was more than inconsequential, but less than material, could occur is more than remote.

Scenario B - Material Weakness. The company processes a significant number of intercompany transactions on a monthly basis. Intercompany transactions relate to a wide range of activities, including transfers of inventory with intercompany profit between business units, allocation of research and development costs to business units and corporate charges. Individual intercompany transactions are frequently material.

A formal management policy requires monthly reconciliation of intercompany accounts and confirmation of balances between business units. However, there is not a process in place to ensure that these procedures are performed on a consistent basis. As a result, reconciliations of intercompany accounts are not performed on a timely basis, and differences in intercompany accounts are frequent and significant. Management does not perform any alternative controls to investigate significant intercompany account differences.

Based only on these facts, the auditor should determine that this deficiency represents a material weakness for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be material, because individual intercompany transactions are frequently material and relate to a wide range of activities. Additionally, actual unreconciled differences in intercompany accounts have been, and are, material. The likelihood of such a misstatement is more than remote because such misstatements have frequently occurred and compensating controls are not effective, either because they are not properly designed or not operating effectively. Taken together, the magnitude and likelihood of misstatement of the financial statements resulting from this internal control deficiency meet the definition of a material weakness.

Example D-2—***Modifications to Standard Sales Contract Terms Not Reviewed To Evaluate Impact on Timing and Amount of Revenue Recognition***

Scenario A – Significant Deficiency. The company uses a standard sales contract for most transactions. Individual sales transactions are not material to the entity. Sales personnel are allowed to modify sales contract terms. The company's accounting function reviews significant or unusual modifications to the sales contract terms, but does not review changes in the standard shipping terms. The changes in the standard shipping terms could require a delay in the timing of revenue recognition. Management reviews gross margins on a monthly basis and investigates any significant or unusual relationships. In addition, management reviews the reasonableness of inventory levels at the end of each accounting period. The entity has experienced limited situations in which revenue has been inappropriately recorded in advance of shipment, but amounts have not been material.

Based only on these facts, the auditor should determine that this deficiency represents a significant deficiency for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be more than inconsequential, but less than material, because individual sales transactions are not material and the compensating detective controls operating monthly and at the end of each financial reporting period should reduce the likelihood of a material misstatement going undetected. Furthermore, the risk of material misstatement is limited to revenue recognition errors related to shipping terms as opposed to broader sources of error in revenue recognition. However, the compensating detective controls are only designed to detect material misstatements. The controls do not effectively address the detection of misstatements that are more than inconsequential but less than material, as evidenced by situations where transactions that were not material were improperly recorded. Therefore, there is a more than remote likelihood that a misstatement that is more than inconsequential but less than material could occur.

Scenario B - Material Weakness. The company has a standard sales contract, but sales personnel frequently modify the terms of the contract. The nature of the modifications can affect the timing and amount of revenue recognized. Individual sales transactions are frequently material to the entity and the gross margin can vary significantly for each transaction.

The company does not have procedures in place for the accounting function to regularly review modifications in sales contract terms. Although management reviews gross margins on a monthly basis, the significant differences in gross margin on individual transaction make it difficult for management to identify potential misstatements. Improper revenue recognition has occurred, and the amounts have been material.

Based only on these facts, the auditor should determine that this deficiency represents a material weakness for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be material, because individual sales transactions are frequently material, and gross margin can vary significantly with each transaction (which would make compensating detective controls based on a reasonableness review ineffective). Additionally, improper revenue recognition has occurred, and the amounts have been material.

Therefore, the likelihood of material misstatements occurring is more than remote. Taken together, the magnitude and likelihood of misstatement of the financial statements resulting from this internal control deficiency meet the definition of a material weakness.

Scenario C – Material Weakness. The company has a standard sales contract, but sales personnel frequently modify the terms of the contract. Sales personnel frequently grant unauthorized and unrecorded sales discounts to customers without the knowledge of the accounting department. These amounts are deducted by customers in paying their invoices and are recorded as outstanding balances on the accounts receivable aging. Although these amounts are individually insignificant, they are material in the aggregate and have occurred consistently over the past few years.

Based on only these facts, the auditor should determine that this deficiency represents a material weakness for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be material, because the frequency of occurrence allows insignificant amounts to become material in the aggregate. The likelihood of material misstatement of the financial statements resulting from this internal control deficiency is more than remote (even assuming that the amounts were fully reserved for in the company's allowance for uncollectible accounts) due to the likelihood of material misstatement of the gross accounts receivable balance. Therefore, this internal control deficiency meets the definition of a material weakness.

Example D-3—***Identification of Several Deficiencies***

Scenario A – Material Weakness. During its assessment of internal control over financial reporting, management identified the following deficiencies. Based on the context in which the deficiencies occur, management and the auditor agree that these deficiencies individually represent significant deficiencies:

- Inadequate segregation of duties over certain information system access controls.
- Several instances of transactions that were not properly recorded in subsidiary ledgers; transactions were not material, either individually or in the aggregate.
- A lack of timely reconciliations of the account balances affected by the improperly recorded transactions.

Based only on these facts, the auditor should determine that the combination of these significant deficiencies represents a material weakness for the following reasons:

Individually, these deficiencies were evaluated as representing a more than remote likelihood that a misstatement that is more than inconsequential, but less than material, could occur. However, each of these significant deficiencies affects the same set of accounts. Taken together, these significant deficiencies represent a more than remote likelihood that a material misstatement could occur and not be prevented or detected. Therefore, in combination, these significant deficiencies represent a material weakness.

Scenario B – Material Weakness. During its assessment of internal control over financial reporting, management of a financial institution identifies deficiencies in: the design of controls over the estimation of credit losses (a critical accounting estimate); the operating effectiveness of controls for initiating, processing, and reviewing adjustments to the allowance for credit losses; and the operating effectiveness of controls designed to prevent and detect the improper recognition of interest income. Management and the auditor agree that, in their overall context, each of these deficiencies individually represent a significant deficiency.

In addition, during the past year, the company experienced a significant level of growth in the loan balances that were subjected to the controls governing credit loss estimation and revenue recognition and further growth is expected in the upcoming year.

Based only on these facts, the auditor should determine that the combination of these significant deficiencies represents a material weakness for the following reasons:

- The balances of the loan accounts affected by these significant deficiencies have increased over the past year and are expected to increase in the future.

- This growth in loan balances, coupled with the combined effect of the significant deficiencies described, results in a more than remote likelihood that a material misstatement of the allowance for credit losses or interest income could occur.

Therefore, in combination, these deficiencies meet the definition of a material weakness.

APPENDIX E

Special Internal Control Over Financial Reporting Considerations for Small and Medium-Sized Companies

E1. Although the five components of internal control over financial reporting apply to every company, regardless of its size, the manner in which each component applies depends on a number of factors, including the:

- Nature and size of the business,
- Diversity and complexity of operations,
- Methods for processing financial information, and
- Applicable legal and regulatory requirements.

E2. The following paragraphs discuss how the five components of internal control over financial reporting might be applied in a typical small or medium-sized company (referred to as a *small company* throughout this section).

E3. *Control Environment***.** The integrity of senior management often plays a critical role in establishing a strong control environment in a small company. Because written policies and procedures at such companies often are less complete or less formal than at large companies, the behavior and interaction of senior managers is critical to an effective control environment. For instance, a small company might not monitor developments in corporate governance best practices or maintain codes of conduct that reflect current best practice except for senior financial officers. However, ethical behavior and core values can still exist and be supported by the senior management through their daily interaction with employees.

E4. In a small company, the actions of senior management play an important role in the control environment. Sometimes, senior management interacts directly with external parties such as critical suppliers, vendors, customers, independent auditors, and regulators. For that reason, their integrity and ethical values are critical.

E5. Another component of the control environment is the organizational structure. A company's size, complexity, and operations determine the proper organizational structure for that company. Generally, larger organizations that have several operating divisions with prescribed responsibilities and reporting protocols are structured more formally than small companies that focus on accomplishing business objectives with only a few employees. The challenge in a small company is to ensure that the organizational structure does not hinder the company's ability to produce reliable financial reports and to safeguard assets.

E6. If a company has not formed an audit committee, Section 301 of the Act states that the entire board of directors will be designated as the audit committee.

E7. *Risk Assessment.* Small companies generally have a less formal risk assessment process than larger ones. Fewer layers of management in a small company often results in more timely and direct communication of risks with senior management. Furthermore, senior managers who are directly involved in business operations often have a more in-depth understanding of the company's processes and, thus, are in a much better position to identify problems with them than are senior managers in a larger organization. For instance, managers involved in the company's day-to-day operations are more likely to be aware of risks posed by the following—

- Variances between actual and expected results.
- Problems with operational or financial data.
- Issues and concerns about operational issues, such as production processes, inventory shortages.
- Complaints and other communications received from customers or vendors.
- Communications received from regulators and other third parties.

E8. Also, once risks are identified, a small company might be able to more quickly develop and implement action plans.

E9. *Control Activities.* As with the risk assessment process, although the concept of control activities in a small company is the same as in a larger one, the formality with which the activities operate might be different. Furthermore, because of the active involvement of senior managers, certain control activities might not be necessary. For example, the CFO's careful review of daily sales and key ratios might be just as effective in a small company as lower level control activities that might be found in a larger business. In fact, the CFO's day-to-day involvement in the company goes a long way in identifying and preventing material errors in the financial statements.

E10. Because of the limited number of employees in a small company, segregation of duties is not always possible. However, even small companies with few employees might be able to achieve adequate segregation of duties by assigning responsibilities wisely. If that is not possible, the president or other senior manager usually can provide the necessary control through his or her direct oversight. For example, procedures performed directly by the CFO (such as signing all checks and reviewing all bank statements and reconciliations) might mitigate the lack of segregation of duties in the cash area.

E11. *Information and Communication.* Although it might be less formal, the process of communication in a small company can be both effective and efficient. Effective communication often is easier to achieve in small companies since they usually have fewer layers of management. In fact, communication often takes place through daily discussions with senior management. Such communication usually is not only more frequent but more effective. Nevertheless, even with frequent and effective communications, smaller public companies need effective accounting systems and most will benefit greatly from modest investments in information technology. Indeed, completely manual accounting systems have almost completely disappeared.

E12. *Monitoring.* Similar to many of the other components previously discussed, the monitoring component in a small company is likely to be informal. Generally, a small company does not have an internal audit department or other group that evaluates internal controls throughout the company. Rather, senior managers often perform monitoring procedures as part of their normal, routine tasks. Sometimes, while performing such procedures, they identify a deficiency in internal control over financial reporting. When other employees identify a deficiency, the few layers of management usually simplify determining to whom communication of the deficiency should be made.

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Exhibit 2(a)(B)

Tab Number	Comment Source
1	Accelerated Edge Incorporated, *Author: M. Murry, Chief Executive Officer*, November 21, 2003
2	Acumen Solutions, *Author: Michael Murphy, Director*, November 5, 2003
3	Advanced Marketing Services, Inc., *Author: Bradley R. Nolte, CPA, Manager - Internal Audit*, October 29, 2003
4	Agilent Technologies, Inc., *Author: Adrian Dillon, CFO*, November 21, 2003
5	Alamo Group, *Author: Dennis M. Stevens, Internal Auditor*, November 4, 2003
6	Allergan Inc., *Author: James F. Barlow, Vice President, Corporate Controller and Principal Accounting Officer*, November 14, 2003
7	The Allstate Corporation, *Author: Samuel H. Pilch, Controller*, November 21, 2003
8	Amerada Hess Corporation, *Author: John Y. Schreyer, Executive Vice President,and Chief Financial Officer*, November 21, 2003
9	America's Community Bankers, *Author: Charlotte M. Bahin, Senior Vice President, Regulatory Affairs*, November 21, 2003
10	American Accounting Association • Auditing Section, Auditing Standards Committee, November 17, 2003
11	American Airlines, *Author: Charlie T. Wright, CIA, CISA, General Auditor*, November 21, 2003
12	American Bankers Association, *Author: Donna Fisher, Director of Tax and Accounting*, December 10, 2003
13	American Bankers Association, *Author: Donna Fisher, Director of Tax and Accounting*, February 5, 2004
14	American Bar Association, Section of Business Law, *Authors: Thomas L. Riesenberg, Chair of the Committee on Law and Accounting of the American Bar Association, Section of Business Law; and Dixie L. Johnson, Chair of the Committee on Federal Regulation of Securities of the American Bar Association, Section of Business Law*, December 2, 2003
15	American Federation of Labor and Congress of Industrial Organizations, Author: Richard L. Trumka, Secretary-Treasurer, November 21, 2003

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16	American Institute of Certified Public Accountants, *Authors: S. Scott Voynich, CPA, Chairman of the Board, and Barry C. Melancon, CPA, President and CEO*, November 21, 2003
17	American Society of Corporate Secretaries, *Author: Marie Oh Huber, Chair, PCAOB Subcommittee, of the ASCS Securities Law Committee*, November 21, 2003
18	Donald Neil Anderson, October 22, 2003
19	Anonymous, November 11, 2003
20	Anonymous, November 13, 2003
21	Anonymous, An Internal Auditor, November 21, 2003
22	Arnall Golden Gregory LLP, *Author: Robert F. Dow, Partner*, November 20, 2003
23	Association for Investment Management and Research, *Author: Patricia Doran Walters, Ph.D., CFA, Senior Vice President, Professional Standards and Advocacy; and Rebecca McEnally, Ph.D., CFA, Vice-President, Advocacy, AIMR*, November 24, 2003
24	The Association of the Bar of the City of New York, *Author: N. Adele Hogan, Chair of Committee on Financial Reporting*, November 21, 2003
25	The Association of Chartered Certified Accountants, November 21, 2003
26	AT&T, *Author: N.S. Cyprus, Vice President and Controller, Chief Accounting Officer*, November 21, 2003
27	Bank of America, *Authors: Francis J. McNichol, Corporate Audit, and Jeffrey R. Watkins, Corporate Audit*, November 21, 2003
28	Bank One Corporation, *Author: Melissa J. Moore, Controller and Chief Accounting Officer, and Jeffrey T. Rigg, General Auditor*, November 24, 2003
29	BDO Seidman, LLP, November 21, 2003
30	BellSouth Corporation, *Author: Raymond E. Winborne Jr., Assistant Vice President - Controller*, November 21, 2003
31	Dennis R. Beresford, Ernst & Young Executive Professor of Accounting, J. M. Tull School of Accounting, Terry College of Business, The University of Georgia, November 8, 2003
32	Silvio Berlusconi, November 21, 2003
33	The Boeing Company, *Author: James A. Bell, Senior Vice President of Finance and Corporate Controller*, November 21, 2003
34	Boise Cascade Corporation, *Author: Ted Crumley, Senior Vice*

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	President and Chief Financial Officer, November 21, 2003
35	BP plc, *Author: Iain Macdonald, Group Vice President and Group Controller*, November 20, 2003
36	Brown-Forman Corporation, *Author: Phoebe A. Wood, Executive Vice President, Chief Financial Officer*, November 21, 2003
37	Brown Shoe Company, Inc., *Authors: Richard C. Schumacher, Senior Vice President and Chief Accounting Officer, and Andrew M. Rosen, Senior Vice President, Chief Financial Officer and Treasurer*, November 19, 2003
38	Business Roundtable, *Author: David L. Shedlarz Executive Vice President & CFO, Pfizer Inc., Chairman-Principle Financial Officers, Subcommittee Corporate Governance Coordinating Committee, Business Roundtable*, November 26, 2003
39	California Public Employees' Retirement System ("CalPERS"), *Author: Mark Anson, Chief Investment Officer*, November 21, 2003
40	California State Teachers' Retirement System, *Author: Jack Ehnes, Chief Executive Officer*, November 20, 2003
41	Canadian Bankers Association, *Author: Kelly Shaughnessy, Vice-President, Banking Operations*, November 21, 2003
42	CARD®decisions Inc., *Authors: Bruce W. McCuaig, B.Comm., CA•CIA, CCSA, and Tim J. Leech, President, FCA•CIA, CCSA, CFE, MBA*, November 21, 2003
43	Cardinal Health, Inc. *Author: Richard J. Miller, Chief Financial Officer*, November 19, 2003
44	Caterpillar Inc., *Author: Ali M. Bahaj, Vice President, Auditing & Compliance Division*, November 21, 2003
45	Bryan Cave, November 24, 2003
46	Cedar Fair, L.P., *Author: Bruce A. Jackson, Corporate Vice President-Finance and Chief Financial Officer*, February 17, 2004
47	Donald H. Chapin, CPA, November 5, 2003
48	Chittenden Corporation, *Author: Howard L. Atkinson, CPA, CIA, Chief Auditor*, November 18, 2003
49	Citigroup, Inc., *Author: William P. Hannon, Controller*, November 21, 2003
50	Commercial Federal Corporation, *Author: Hal Garyn, Senior Vice President – Director of Audit and Risk Services*, November 21, 2003
51	Commonwealth of Virginia, *Author: Walter J. Kucharski, Auditor of Public Accounts*, November 19, 2003

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52	Community Bankers Association of New York State, *Author: Mariel O. Donath, President & CEO*, November 24, 2003
53	Computer Sciences Corporation, *Author: Leon J. Level, Chief Financial Officer*, November 21, 2003
54	Computer Sciences Corporation, *Author: Leon J. Level, Chief Financial Officer*, March 8, 2004
55	Confederation of British Industry, *Author: Clive Edrupt, CBI Company Affairs*, November 28, 2003
56	Congressional Members: Gregory W. Meeks, Barbara Lee, Julia Carson, WM. Lacy Clay, Major Owens, William J. Jefferson, Juanita Millender-McDonald, Carolyn Kilpatrick and Stephanie Tubbs-Jones, February 8, 2004
57	Cooper Tire & Rubber Company, *Author: Phil Kortokrax, Director of Internal Audit*, November 25, 2003
58	Council of Institutional Investors, *Author: Sarah A.B. Teslik, Executive Director*, November 24, 2003
59	Covington & Burling, *Author: Bruce C. Bennett*, November 21, 2003
60	Credit Suisse Group, *Authors: Philip Ryan, Chief Financial Officer, and Rudolf Bless, Chief Accounting Officer*, November 21, 2003
61	Crowe Chizek and Company LLC, November 24, 2003
62	Cummins Inc., *Authors: John Hurless and Pam Tripp*, November 21, 2003
63	Lawrence A. Cunningham, Visiting Professor of Law, Vanderbilt University, Professor of Law & Business, Boston College, November 4, 2003
64	Defense Contract Audit Agency, Department of Defense, *Author: Robert DiMucci, Assistant Director, Policy and Plans*, November 21, 2003
65	Deloitte & Touche LLP, November 21, 2003
66	Deluxe Corporation, *Authors: Lawrence J. Mosner, Chairman and Chief Executive Officer, Douglas J. Treff, Senior Vice President and Chief Financial Officer, Katherine L. Miller, Vice President, Controller and Chief Accounting Officer*, November 21, 2003
67	Dixon Odom PLLC, *Author: S. Walter McNairy, Jr., Director of SEC Services*, November 2, 2003
68	Dover Corporation, *Authors: Michael B. Stubbs, chairman, Audit Committee, Robert G. Kuhbach, Vice President, Finance & Chief Financial Officer, and Raymond T. McKay, Jr., Controller & Chief*

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	Accounting Officer, November 19, 2003
69	Charles R. Drott, November 19, 2003
70	Eastman Kodak Company, *Author: Robert H. Brust, Chief Financial Officer and Executive Vice President*, November 21, 2003
71	Edison Electric Institute, *Author: David K. Owens, Executive Vice President – Business Operations Group*, November 21, 2003
72	E. I. du Pont de Nemours and Company, *Author: Daniel B. Smith, Vice President & Controller*, November 21, 2003
73	Eli Lilly and Company, *Author: Arnold C. Hanish, Executive Director, Finance, and Chief Accounting Officer,* November 21, 2003
74	Emerson, *Author: Richard J. Schlueter, Vice President and Chief Accounting Officer*, November 24, 2003
75	The Empire District Electric Company, *Author: William L. Gipson, President and Chief Executive Officer*, November 21, 2003
76	EMS companies (Solectron, Flextronics, Celestica and Sanmina-SCI), *Authors: Warren Ligan, Corporate VP and Corporate Controller, Solectron Corporation; Chris Collier, Corporate Controller, Flextronics International Ltd; Peter J. Bar, VP and Corporate Controller, Celestica Corporation; and Mark Lustig, VP and Corporate Controller, Sanmina-SCI*, November 21, 2003
77	EnCana Corporation, *Author: Ron H. Westcott, Vice-President and Comptroller*, November 21, 2003
78	Enpria, November, 21, 2003
79	Ernst & Young LLP, November 21, 2003
80	Fédération des Experts Comptables Européens – European Federation of Accountants, *Author: David Devlin*, President, November 21, 2003
81	Financial Executives International, *Authors: Frank Brod, Chair, Committee on Corporate Reporting, and Kate Asbeck, Chair, PCAOB Subcommittee, Committee on Corporate Reporting*, November 20, 2003
82	Financial Management Division of the Securities Industry Association, *Author: Marshall J Levinson, President*, November 21, 2003
83	First Commonwealth Financial Corporation, *Authors: John J. Dolan, Executive Vice President and Chief Financial Officer, and Leonard V. Lombardi, Sr. Vice President, Internal Audit*, November 21, 2003
84	Florida Institute of Certified Public Accountants, *Author: Lizette*

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	Pena, CPA, Chair; Committee members coordinating this response: Kathryn M. Means, CPA, Vice-Chair and Joel S. Baum, CPA, November 21, 2003
85	Ford Motor Company, *Author: James C. Gouin, Vice President and Controller*, November 21, 2003
86	Steven A. Forrest, November 21, 2003
87	General Mills, Inc., *Author: Kenneth L. Thome, Senior Vice President, Financial Operations*, November 21, 2003
88	Glass, Lewis & Co., LLC, *Author: Lynn E. Turner, Managing Director of Research*, December 2, 2003
89	GlaxoSmithKline Services Unlimited, *Author: Paul F. Blackburn, SVP, Corporate Accounting*, November 21, 2003
90	Goldman Sachs & Co., *Author: Sarah E. Smith, Chief Accounting Officer*, November 21, 2003
91	Grant Thornton LLP, *Author: John L. Archambault*, November 21, 2003
92	Jim Grinham, October 15, 2003
93	Guidance Software, Inc., *Author: Victor T. Limongelli, General Counsel*, November 14, 2003
94	Harsco Corporation, *Author: Layne Kocher, C.P.A., Director – Internal Audit*, November 21, 2003
95	The Hartford Financial Services Group, Inc., *Author: Robert J. Price, Senior Vice President and Controller*, November 20, 2003
96	Health Insurance Plan of Greater New York, *Author: Michael D. Fullwood, Executive Vice President, Chief Financial Officer, Secretary and General Counsel*, November 20, 2003
97	Kevin S. Holder, CPA, November 3, 2003
98	The Home Depot, *Author: Carol Tomé, Executive Vice President and Chief Financial Officer*, November 21, 2003
99	Illinois CPA Society, The Audit and Assurance Services Committee, *Authors: William P. Graf, Chair, Audit & Assurance Services Committee, and Scott P. Bailey, Chair, Comment Letter Subcommittee*, November 21, 2003
100	Independent Community Bankers of America, *Author: C.R. Cloutier, Chairman*, November 20, 2003
101	Information Systems Audit and Control Association (ISACA) and IT Governance Institute (ITGI), *Author: Marios Damianides, CISA, CISM, CA, CPA, 2003-2004 International President*, November 21,

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	2003
102	ING Americas, *Author: Jorn Rose, Chief Auditor*, November 21, 2003
103	Institut der Wirtschaftsprüfer, *Authors: Klaus Peter Naumann, Chief Executive Officer, and Horst Kreisel, Technical Manager*, November 21, 2003
104	The Institute of Chartered Accountants in England & Wales, *Author: Robert Hodkinson, Director, Technical*, November 21, 2003
105	The Institute of Internal Auditors, *Author: William G. Bishop III, CIA, President*, November 21, 2003
106	Intel Corporation, *Author: Jim Campbell, Corporate Controller*, November 20, 2003
107	Irwin Financial Corporation, *Author: Will Miller, Chairman & CEO*, November 21, 2003
108	The Jamaica Public Service Company, Limited, *Author: Juliet Ramsigh, Head of Internal Audit*, November 12, 2003
109	Jefferson Wells International, *Author: George Herrmann, Vice President and Chief Financial Officer*, November 21, 2003
110	Johnson & Johnson, *Authors: Ronald G. Fulop, Vice President, Corporate Internal Audit, and Stephen J. Cosgrove, Corporate Controller*, November 21, 2003
111	JPMorgan Chase & Co., *Author: Joseph L. Sclafani, Executive Vice President and Controller*, November 21, 2003
112	Kimball International Inc., *Author: Robert F. Schneider, Executive Vice President,Chief Financial Officer, Treasurer*, October 16, 2003
113	Kimball International, Letter to Senators Bayh and Lugar, and Congressman Hill, *Authors: Douglas A. Habig, Chairman, Chief Executive Officer, and James C. Thyen, President*, November 18, 2003
114	David Kowalczyk, November 13, 2003
115	KPMG LLP, November 21, 2003
116	David Leach, CPA, CIA, Director Internal Audit, SEC Registrant whose share are listed on the NYSE, November 25, 2003
117	Richard Lee, November 5, 2003
118	Lincoln National Corporation, *Author: Casey J. Trumble, Senior Vice President, Tax & Reporting*, November 21, 2003
119	William L. Livingston, PE, November 21, 2003
120	Lockheed Martin Corporation, *Author: Rajeev Bhalla, Vice President*

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	and Controller, November 21, 2003
121	Stephen Lucas, November 13, 2003
122	JC Mahecha, CPA, February 26, 2004
123	Manufacturers Alliance/MAPI, *Author: Francis W. Holman, Jr., Vice President and Secretary*, November 21, 2003
124	Marriott International, Inc., *Author: Matthew Gagnon, IR Audit Director*, October 28, 2003
125	Matthew Leitch Associates Limited, *Author: Matthew Leitch*, November 8, 2003
126	John P. McAllister, Ph.D., CPA, Chair & Professor of Accounting, Coles College of Business, Kennesaw State University, November 18, 2003
127	McGladrey & Pullen, LLP, November 21, 2003
128	Meredith Corporation, *Author: William T. Kerr Chairman and Chief Executive Officer*, March 4, 2004
129	Georg Merkl, October 28, 2003
130	MGIC Investment Corporation, *Author: Gary A. Antonovich, Vice President - Internal Audit*, November 20, 2003
131	Microsoft Corporation, *Author: Scott Di Valerio, Vice President, Corporate Controller*, November 21, 2003
132	Motorola, Inc., Author: Steven J. Strobel, Senior VP and Corporate Controller, November 21, 2003
133	National Association of Black Accountants, *Author: Darryl R. Matthews, Sr., Executive Director and COO*, November 21, 2003
134	National Association of State Boards of Accountancy, *Authors: David A. Vaudt, CPA, Chair, and David A. Costello, CPA, President & CEO*, November 20, 2003
135	National City Corporation, *Author: James P. Gulick, Senior Vice President, General Auditor*, November 21, 2003
136	National State Auditors Association, *Author: William G. Holland, President, NSAA*, November 21, 2003
137	National Venture Capital Association, *Author: Mark G. Heesen, President*, January 9, 2004
138	The New York Clearing House Association L.L.C., *Author: Jeffrey P. Neubert, President and CEO*, November 21, 2003
139	New York State Bar Association, Business Law Section, Committee on Securities Regulation, *Author: Michael J. Holiday, Chair of the Committee*, November 25, 2003

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140	New York State Society of Certified Public Accountants, *Author: Jeffrey R. Hoops, President*, November 21, 2003
141	Northrop Grumman Corporation, *Author: Steven J. Root, Director Finance Administration and Process*, December 4, 2003
142	Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, *Authors: Zane D. Blackburn, Chief Accountant, Office of the Comptroller of the Currency; Gerald A. Edwards, Jr., Associate Director and Chief Accountant –Supervision, Federal Reserve Board; Robert F. Storch, Chief Accountant, Federal Deposit Insurance Corporation; and Timothy J. Stier, Chief Accountant, Office of Thrift Supervision*, December 1, 2003
143	Ohio Retirement Systems, *Authors: J.P. Allen, Chair, Highway Patrol Retirement System; Robert M. Beck, Chair, Ohio Police and Fire Pension Fund; Charlie Adkins, Chair, Public Employees Retirement System of Ohio; Eugene E. Norris, Chair, State Teachers Retirement System of Ohio; and Barbara J. Miller, Chair, School Employees Retirement System of Ohio*, November 24, 2003
144	Don M. Pallais, CPA, November 18, 2003
145	Pearson PLC, *Author: Rona Fairhead, Chief Financial Officer*, November 24, 2003
146	Penn Virginia Corporation, *Author: Frank A. Pici, Executive Vice President and Chief Financial Officer*, November 21, 2003
147	Penn Virginia Resource Partners, L.P., *Author: Frank A. Pici, Vice President and Chief Financial Officer*, November 21, 2003
148	Pentair, Inc., *Author: David Harrison, Executive Vice President and Chief Financial Officer*, November 25, 2003
149	Perisho Tombor Loomis & Ramirez, *Author: James C. Perisho, CPA*, October 26, 2003
150	Pfizer Inc., *Author: Loretta V. Cangialosi Vice President and Controller*, November 21, 2003
151	Piercy, Bowler, Taylor & Kern, *Authors: L. Ralph Piercy, President and Managing Shareholder, and Howard B. Levy, Director, Technical Services (Former Member, Auditing Standards Board)*, November 21, 2003
152	Zona Porter, November 21, 2003
153	Robert Posner, Retired Public Accountant, November 6, 2003
154	PPG Industries, Inc., *Author: William H. Hernandez, Sr. Vice*

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	President, Finance, November 18, 2003
155	PricewaterhouseCoopers LLP, November 21, 2003
156	Principal Financial Group, *Author: Kirk L. Tibbetts, Project Sponsor – SOX 404*, November 21, 2003
157	PROTIVITI INC., *Author: James W. DeLoach, Jr., Managing Director*, November 21, 2003
158	PSEG Services Corporation, Author: Kathy A. Fudali, Director, Internal Controls, November 21, 2003
159	Michael J. Ramos, November 21, 2003
160	Reliant Resources, Inc., *Author: Christopher Lozier, Director Internal Control Effectiveness*, November 21, 2003
161	Risk Management Advisory Services, LLC, *Author: Bernard Bethke, CPA, CISA*, November 17, 2003
162	Robert Chira & Associates, *Author: Robert Chira*, October 24, 2003
163	Safeway Inc., *Author: David F. Bond, Senior Vice President – Finance and Control*, November 21, 2003
164	Ralph S. Saul, October 30, 2003
165	Roger W. Schipke, November 20, 2003
166	Larry J. Scott, CPA, November 19, 2003
167	Rod Scott, October 29, 2003
168	Shell International Ltd., *Author: Tim Morrison Group Controller*, November 21, 2003
169	Southern Union Company, *Author: Jon A. Graf, Vice President and Controller*, November 21, 2003
170	State of Wisconsin Investment Board, *Author: Keith Johnson, Chief Legal Counsel*, November 24, 2003
171	Sun Life Financial Inc., *Author: Robert C. Salipante, President, Sun Life Financial U.S.*, November 21, 2003
172	Greg Swalwell, November 20, 2003
173	Swiss Institute of Internal Auditing, *Author: Hans-Ulrich Pfyffer*, November 20, 2003
174	Technology Solutions Company and CRS Associates LLC, *Author: Malcolm Schwartz, Senior Vice President, Technology Solutions Company And COO, CRS Associates LLC*, November 25, 2003
175	Telephone and Data Systems, Inc., *Author: Joe Read*, November 21, 2003
176	Texas Instruments Incorporated, *Author: Melanie L. Merrion, Accounting Research Manager*, November 21, 2003

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177	Texas Society of Certified Public Accountants, *Author: C. Jeff Gregg, CPA, Chair, Professional Standards Committee*, November 21, 2003
178	TiVo Inc., *Author: David Higginbotham, Assistant Controller and Chairman, Sarbanes-Oxley Compliance Committee*, October 20, 2003
179	Jonathan Trevathan, November 18, 2003
180	UBS AG, *Authors: Walter Stuerzinger, Group Chief Risk Officer, and Hugo Schaub, Group Controller*, November 19, 2003
181	Union State Bank, *Author: Thomas E. Hales, Chairman of the Board, President, and Chief Executive Officer*, November 21, 2003
182	United States General Accounting Office, *Author: David M. Walker, Comptroller General of the United States*, December 9, 2003
183	United States Steel Corporation, *Author: Gretchen R. Haggerty, Executive Vice President, Treasurer & Chief Financial Officer*, November 21, 2003
184	United Technologies Corporation, *Author: Jay L. Haberland, Vice President, Business Controls*, November 19, 2003
185	The Value Alliance and Corporate Governance Alliance, *Author: Eleanor Bloxham, President*, November 21, 2003
186	Roger Vanzanen, Internal Audit, November 12, 2003
187	Curtis C. Verschoor, Research Professor, School of Accountancy and MIS, DePaul University, November 21, 2003
188	The Walt Disney Company, *Author: Brent A. Woodford, Senior Vice President, Corporate Controllership*, November 21, 2003
189	Watson Rice LLP, *Author: Raymond P. Jones, CPA, CFE, Managing Partner*, November 21, 2003
190	Williams Law Group, P.A., *Author: Michael T. Williams*, November 14, 2003
191	Wells Fargo & Company, *Author: Richard D. Levy, Senior Vice President, Controller*, November 21, 2003
192	H. W. Willoughby, November 21, 2003
193	Rose Mary Woods, November 24, 2003
194	Yellow Corporation, *Author: Gary Mielke, Director Audit*, November 21, 2003

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November 18, 2003

Office of the Secretary
PCAOB
1666 K Street NW
Washington, D. C. 20006-2803

Ref: PCAOB Rulemaking Docket Matter Number 008

Dear Mr./Ms. Secretary:

Thank you for the opportunity to comment on the proposed Auditing Standard (the "Standard"). As a director of public and private companies, my interest is in enhancing the quality of information available to exercise my fiduciary duty to protect the interests of shareholders. One source of facts on which directors rely is the external audit.

I commend the PCAOB for including in the definition of internal controls "operating efficiency and effectiveness and compliance with applicable laws and regulations" (page 4) and in the audit standards a review of ". . . controls that focus primarily on effectiveness and efficiency of operations or compliance with laws and regulations. . . ." (Appendix A, Paragraph 14, p. A-11) The definition goes on to incorporate "safeguarding of assets."

These three factors: operating efficiency and effectiveness, compliance with laws and regulations and safeguarding of assets are at the crux of regaining shareholder confidence. Financial statements, after all, represent the results of operations and corporate conduct.

Illegal, illicit or the ***appearance*** of unethical corporate behavior is what shakes shareholder confidence. Section 302 of the Sarbanes-Oxley Act requires executives to certify information contained in reports "fairly present in all material respects the financial condition and results of operations of the issuer." It requires both "financial condition" ***and*** "results of operations." It is a misstatement of material fact for executives to certify they have reviewed their controls and processes and found them to be effective when they turn a blind eye to illegal and unauthorized activity. The legal exposure and subsequent headline risk to the business materially impacts a company's performance.

Legal proceedings are lengthy, costly and disruptive to operations. If a company is at risk for violating a law – whether knowingly or unintentionally – stakeholders require a heads up. Stakeholders relying on the accuracy of financial statements must have confidence that the reports reflect adherence to all laws and regulations. They expect the audit to confirm (1) companies run well, (2) assets are protected, (3) corporate conduct is responsible and (4) companies obey the law.

With the thought in mind that financial reports ***represent*** the operating condition and corporate conduct, the proposed Standard does not go far enough to protect interests of stakeholders. Throughout the document, the Standards hedge on the real meat of the audit by qualifying ". . . which also have a material affect on reliability of financial reporting." In Appendix C the Standards capitulate on the strength of the protection of assets by citing: "the auditor is not required to understand and test controls over management's decision-making processes for all sales and acquisitions." This hedge enables auditors to overlook processes that affect the company's ability to operate within the law. While it is inappropriate for the auditor to second-guess management's decision-making, it should be on the auditor's radar screen whether processes or lack of controls fail to protect assets, cause the company to run poorly or permit the company to break laws or violate regulations.

Case in point, software license compliance. When management permits employees to load software on company computers without prior authorization and proper documentation, it not only violates agreements with software developers, it is a federal crime. Fines, fees, damages and settlements are material. Yet failure to have internal controls to prevent the illegal activity is a dereliction of management responsibility.

By limiting the audit to those information technology controls on which other controls are dependent (#41 page A-20), instead of focusing on the real meat of shareholder concern and the intent of Congress, auditors are focused on reviewing software code rather than auditing the events, processes and procedures the reports ostensibly represent. Excluding from consideration specific legal requirements all companies are expected to adhere to, the PCAOB gives tacit approval to auditors to ignore adherence to laws. The use of software without proper licenses and proofs of purchase is material, affects operating results and impacts the financial reports which represent those results of operations.

While the Standard requires audit of information technology general controls, its lack of spelling out for auditors the inclusion of acquisition, deployment, implementation, use and disposition of software – whether packaged or custom developed – has enabled audit firms to omit it from their internal control testing in their audit plans.

The emphasis on financial reporting rather than the events and activities the statements represents defies the intent of Congress and fails to protect shareholder interests. It serves merely to mollify and shield auditors from making attestations about company operations, giving them wiggle room when called to task.

The Securities and Exchange Commission recognizes the COSO framework in its adoption of Final Rule: Management Reports on Internal Controls Over Financial Reporting and Certification . . . "The scope of internal control therefore extends to policies, plans, procedures, systems, activities, functions, projects, initiatives and endeavors of all types at all levels of a company." The final rule defines internal control over financial reporting as "a process . . . to provide reasonable assurance regarding the reliability of financial reporting. . . . and includes those policies and procedures that . . . (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a material effect on the financial statements."

The Standard recognizes operational considerations and incorporates tone-at-the-top and "adherence to laws and regulations" in the control environment. It is simple to test the control environment, tone-at-the-top, the integrity and values of top management and corporate culture. If management cannot produce one license plus proof of right to use the license (proof of purchase) and chain of ownership (record retention) for each instance of a program found on company computers, the courts have upheld the company is out of compliance. This black-and-white, open-and-shut approach is telling of a management that allows unethical practices to run rampant in a company and has dire consequences on company performance and financial results.

U.S. businesses lose $2.2 billion annually from unlicensed use of software. It is material. A review of the MultexInvestor database on November 14, 2003 reveals that for 16% of all public companies, misuse of software assets would have a material impact on results. For 28% of public companies, the average settlement in litigation involving misappropriation and misuse of software indicates a significant deficiency.

The PCAOB should require auditors to attest to the efficiency and effectiveness of operations, effectiveness of controls and processes designed to protect assets and assure adherence to laws and regulations. I ask the PCAOB to adopt strong audit requirements for effectiveness of processes and controls for adherence to laws and specifically, software license compliance. The alternative is to force government agencies and the courts to impose further regulation on U.S. business. It is far preferable it remain the domain of self-regulatory environment rather than revert to government oversight.

Respectfully submitted,

M. Murry

M. Murry
Chief Executive Officer
Accelerated Edge Incorporated

From: Murphy, Mike [mmurphy@acumensolutions.com]

Sent: Wednesday, November 05, 2003 4:02 PM

To: Comments

Subject: Docket 008

For the PCAOB

I believe the definitions of significant deficiency and material weakness are too vague. There is no clear delineation between the two, and this will lead to much wasted time and debate between firms and their auditors.

Recommend the definitions be clarified. Supplement the definitions by using numerous examples to illustrate the PCAOB's intent. Another suggestion would be to come up with some sort of rule of thumb based on percent (%) of revenue impacted, or potentially impacted by the issue(s).

Thank you

Michael Murphy
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From: bradleyn@ADVMKT.COM
Sent: Wednesday, October 29, 2003 7:20 PM
To: Comments
Subject: PCAOB Rulemaking Docket Matter No. 008

Terms Table.doc
(34 KB)

The roundtable discussion highlighted the confusion concerning the definitions of internal control deficiency, significant deficiency and material weakness. The first five paragraphs of the "Evaluating the Results and Forming an Opinion" section (pg. 8 of 12) of the Proposed Auditing Standard aim to clarify the definitions. The problem is that you have to read those five paragraphs several times to conceptualize the differences in definition and treatment between internal control deficiency, significant deficiency and material weakness. I think the PCAOB's definitions for internal control deficiency, significant deficiency and material weakness should be presented in a table (please see attached). Something like this is easier to grasp than the first five paragraphs of the section mentioned above.

Best Regards,

Brad

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<<Terms Table.doc>>

Terms Used in Evaluating the Results and Forming an Opinion

Term	Definition	Action(s) Required by the Auditor
Internal Control Deficiency	Exists when the design or operation of a control does not allow the company's management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.	• The auditor is required to evaluate the severity of all identified internal control deficiencies because such deficiencies can have an effect of his or her overall conclusion about whether internal control is effective. • The auditor also has a responsibility to make sure that certain parties, such as the audit committee, are aware of internal control deficiencies that rise to a certain level of severity. • The auditor also is required to communicate in writing to the company's management all internal control deficiencies of which he or she is aware and to notify the audit committee that such communication has been made.
Significant Deficiency	An internal control deficiency (or a combination of internal control deficiencies) should be classified as a significant deficiency if it results in more than a remote likelihood of misstatement of the company's annual or interim financial statements that is more than inconsequential in amount.	• The auditor is required to communicate in writing to the company's audit committee all significant deficiencies of which the auditor is aware.
Material Weakness	A significant deficiency should be classified as a material weakness if, by itself or in combination with other internal control deficiencies, it results in more than a remote likelihood of a material misstatement in the company's annual or interim financial statements.	• The auditor is required to communicate in writing to the company's audit committee all material weaknesses of which the auditor is aware. • Most importantly, if a material weakness exists as of the end of the company's most recent fiscal year, management and the auditor must conclude that the internal control is ineffective.

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Agilent Technologies

November 20, 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

Dear Board Members:

Thank you for the opportunity to comment on the Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of the Financial Statements*. We firmly believe that the PCAOB has an historic role to play in leading the reform of public companies' financial reporting processes, which should ultimately help to restore and increase investor confidence and security to new levels. As a public company, we depend on the Board to use care and a balanced approach to ensure that not only is the end goal achieved, but that no significant unintended consequences impede that goal. Agilent Technologies, Inc. (Agilent) is a global technology leader in communications, electronics, life sciences and chemical analysis. The company's approximately 29,000 employees serve customers in more than 110 countries. On behalf of Agilent, we offer the following comments with regard to the proposed standards for your consideration.

EXECUTIVE SUMMARY

1) Significant Deficiency and Material Weakness Definitions

We appreciate the Board's attention to the importance of clear definitions in the attestation process. However, the exposure draft has dropped the materiality threshold for what is considered to be a significant deficiency or a material weakness. Under the proposed rules, a shortcoming that is neither significant nor material can nevertheless qualify for one of these labels, with serious consequences.

The exposure draft states that a circumstance that creates more than a "remote" likelihood of a misstatement, which is more than "inconsequential" in amount, qualifies as a significant deficiency. The word "inconsequential" is not defined and will likely be interpreted differently. Many companies could point to a control activity failure that has a 10% probability of occurring and involves potential monetary amounts that are 5-10% of what those companies would consider "material." Although the likelihood of such an occurrence is small and the monetary amounts are not material, this, under example D-1, Scenario A, might be a significant deficiency.

If these definitions are retained, we ask the PCAOB to consider and clarify whether the relevant monetary threshold is the dollar impact that could reasonably occur, or the maximum financial impact under a worse case scenario. Currently, the PCAOB proposed definitions would include a number of scenarios from the worst case; ranging from more than remote likelihood with a material impact, to a probable likelihood with a very small impact. Is the intention of the PCAOB to cover this wide range of probability in required disclosures to the audit committee?

A review of the exposure draft examples reveals that the exceedingly low threshold proposed, exponentially increases the risk that companies will trigger multiple significant deficiencies; without regard to any compensating controls. Example D-1, Scenario A on its face seems to be an example of a deficiency, not a significant deficiency, especially given the compensating controls in place to catch material errors. The proposed standard will lead to disclosure of many significant deficiencies which may aggregate to a material weakness judgment and which may cause shareholders and third parties to consider the risk of material misstatement to be much greater than it actually is. This in turn may bring unwarranted volatility in a company's stock price. We are also concerned that the proposed standards will open the door for litigation against companies when an adverse internal control report is issued even though the company's financials are accurate and fairly presented.

2) Use of Internal Audit

With the statement that "the more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be.", the Board has wisely recognized the fiscal benefit to companies of a strong internal audit function. In other portions of the proposed standards, the exposure draft seems to move away from the above statement. While certain sections encourage the use of management, including internal audit, other provisions limit the circumstances in which internal audit may be used. The draft proposes that internal audit cannot be utilized for the following areas:

- Control environment, including fraud controls.
- Controls over period-end financial reporting process.
- Controls that have a pervasive effect on the financial statements, such as certain IT general controls on which the operating effectiveness of other controls depend.
- Walk throughs.

These prohibited functions are some of the key areas in which an internal audit group can provide significant insight and audit evidence based on its experience with the company. Public companies would not expect external auditors to rely solely on internal audit for 100% of testing, but to eliminate internal audit from these critical areas is a dramatic change from present accepted practices. In addition, this proposed point does not allow the external auditors latitude to use their own professional judgment.

We urge the Board to utilize the provisions of Statement of Auditing Standards No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, which address the relationship of the internal audit function in the external audit of financial statements. Rather than redefining this relationship, it would seem that the Board's standard should extrapolate the SAS 65 standards to the audit of internal control over financial reporting especially given that external auditors are now required to perform an integrated audit of financial statements and internal control over financial reporting.

3) Scope of Procedures External Auditors Are Required To Perform

We are concerned that the exposure draft contains a dramatic increase in the number of procedures that external auditors are required, or are planning to, perform and document. Due to fears that their CPA firms may not pass a PCAOB quality audit, as well as mindful of the litigation that would follow, it is logical to assume that external auditors will feel required to perform every procedure in detail even when circumstances would not otherwise dictate such actions. Coupled with the requirement to seek out anything that is more than inconsequential, the proposed rules create an unprecedented amount of painstaking procedures. The exposure draft provides opportunities for assistance from internal audit functions but, as discussed above, these have been greatly reduced. For CPA firms to meet these very substantive new requirements, such firms are proposing to raise fees approximately 25 to100%.

In the area of "walkthroughs" it is not clear if all processes in all locations (significant or otherwise) must have a "walkthrough." By way of example, Agilent, as other multinationals, has complex global operations with an extensive list of processes located in numerous geographies involving multiple sites. In addition, some financial transactions are performed in shared service centers while some are not. This leads to a complex environment that may have many different possible scenarios for walkthroughs. We believe the CPA firm should be allowed to use its judgment based on the specific circumstances of the company that it is evaluating to determine which "walkthroughs" are significant.

Sample sizes for testing of internal controls must also be taken into account. Multinational corporations with operations in multiple geographies could have a large number of immaterial entities and operations. If the company is required to view those immaterial operations together, this creates the potential for a material problem through the aggregation of these entities, only if they all in combination, have a problem. This is extremely unlikely. A careful reading of the exposure draft leads to the conclusion that a company's CPA firm or internal audit is obligated to test all of these small organizations yearly since in combination they could be material and since no rotation is allowed. While the chances of a material problem occurring are probably well below remote, large corporations, their internal audit functions and CPA firms will be forced to allocate time and shareholder dollars to these relatively insignificant operations rather than to significant operations. If a problem with a material operation is overlooked because of this allocation of resources, both the corporation and the investing public suffer.

4) Scope of Procedures Public Companies Are Required To Perform

We are concerned that the exposure draft is unclear as to the level of testing and documentation required by management. The proposed standards require external auditors to evaluate a number of proscribed procedures that a public company must perform in order to receive a "clean" opinion on their internal control over financial reporting from their auditors. If left unclarified, in light of the points mentioned in Item 3 above, external auditors can be expected to take a very conservative view of management testing and documentation. This would necessitate a considerable increase in the number of procedures that a public company would need to document and perform to avoid the external auditors declaring a significant deficiency or a material weakness. The type of evidence that a public company would be required to produce would far exceed the guidance currently given by the SEC to obtain reasonable assurance that a company's internal control over financial reporting is working effectively. For a public company of Agilent's size and complexity, the amount of documentation, evaluation and self-testing will be significant.

As stated before, Agilent has 5 main businesses, located in approximately 30 geographies with multiple sites, some of which may or may not be shared. In addition, some financial transactions are performed in shared service centers while some are not. Each of these different scenarios will need to be assessed by the company to determine what impact, if any, there could be to the internal control over financial reporting. In addition, this assessment will need to be reperformed throughout the year as a company of our size is not static. Then, the company will need to document the internal controls in those impacted areas and periodically test. In addition, the company will need to monitor and test, at an extremely low level, any changes that occur during the year to ensure that the internal controls are working effectively. This will require an incredible amount of effort to just provide adequate documentation, which will take away from the company's focus on those most significant and critical potential issue areas.

In addition, we believe that if a company is required to provide evidence of that control effectiveness to the extremely low level required by the proposed standards, the level of work performed by our external auditors will need to be at the same level or lower. Also, even though the internal control over financial reporting may be working effectively, if we are missing documentation around these controls or our self-testing, our external auditors may determine this situation is, at the minimum, a significant deficiency and potentially a material weakness. Again, the level of documentation, evaluation and testing by both the company and their external auditor may force the cost of implementing the proposed standards to exceed the benefit achieved by more effective internal control over financial reporting.

5) Service Providers

We respectfully request the Board to reconsider what companies must produce as required evidence of the internal controls of their service providers. Due to the potential impact and breadth of this issue, we believe that it may be best to defer the final rules effective date, in this area, for one year.

A SAS 70 report is an accepted United States standard, though it is a report that is expensive ($50,000 to $70,000) and time-consuming to produce. However, it may be considered reasonable to require a nationally-recognized service provider such as Fidelity or ADP to obtain a SAS 70 report yearly. But, as company fiscal years vary, will a CPA firm be allowed to rely on a 10-month old SAS 70 evaluation? If not, there will be a need to have service providers change their procedures and deliverables. Companies with non-standard fiscal calendars may not have the ability or the resources to pressure these service providers to deliver on the new requirements in time to meet their next SEC filing deadlines. Companies are also unlikely to have the contractual right to review any of the service provider's controls themselves. If there is no SAS 70 report the auditor will have to perform significant alternative procedures at a high cost to the public company. Add to this the complexity of using international service providers in dozens of countries. These service providers are not familiar with Sarbanes Oxley's Section 404 requirements and are naturally quite resistant to new requests to produce a detailed certification of their internal functions, utilizing a standard that may not comport with their local regulatory framework.

The end result for a U.S. corporation might be the need to terminate a beneficial relationship with a foreign service provider who will not, or cannot, meet the Board's requirements. The detrimental effect to the U.S. company is clear, as operations would need to be transitioned, workers terminated and new workers hired and trained, with the attendant legal complications, loss of local beneficial arrangements, and perhaps lawsuits or penalties. As the U.S. economy teeters on the edge of recovery, with the fate of U.S. companies hanging on the balance, locating a new service provider who can meet the PCAOB requirements as well as the corporation's requirements in a short period of time is very risky. These risks directly impact the ability of a company such as Agilent to produce quality products and services and our ability to generate profit.

6) Evaluating the Effectiveness of the Audit Committee

We believe that more guidance is necessary to understand the extent of the Board's requirements for evaluating the effectiveness of the audit committee. In the infamous Enron audit committee failure, it should have been clear to Enron's external auditors what the relative levels of effectiveness were for each member of the committee. As a result of the PCAOB proposed standards, CPA firms are now planning significant audit procedures -- including lengthy surveys and interviews with the audit committee -- to fulfill the evaluation requirement. In reality, after working with the audit committee for a year, an external auditor should be able to determine rather quickly if the audit committee is effective. The added benefit of surveys and interviews at the end of the year appears to be quite small, while the detriment is a procedural burden for audit committee members whose time is better spent on their other duties. While the ability to oversee the preparation of audited financials and disclosure is a key function of an audit committee, this is not the only role that it plays. We question whether external auditors are the proper arbiters of the overall effectiveness of an audit committee. Ultimately, the company must make that decision. In addition, there is an inherent conflict of interest in asking the external auditors to evaluate the audit committee.

* * *

Agilent supports what we initially perceived Section 404 to be: A primer on what proper level a company's internal controls system should be operating at, which would provide a reasonable basis of assurance that material errors would be prevented and detected prior to being included in the financial statements. We have seen Section 404 evolve into an attempt to go from reasonable assurance to almost absolute assurance. The average industry process relies on an approximately 95-97% confidence level that things will perform as planned. The cost to increase a percentage point of confidence is not a linear increase but rather an exponential increase. In judging the effect of the proposed regulations, to move from 96 to 97% does not equal one percentage point of additional effort, but rather might be 100 to 500% more effort and cost. At Agilent, we believe that strong internal controls pay for themselves, but the suggested level of analysis, disclosure, documentation and assurances proposed to implement Section 404 exceed what is reasonably required and will force companies to spend significantly beyond any type of benefit. The impact of this will be the loss of productivity and company jobs, lower R&D spending and innovation, and a diminished focus on customers and industries by top managers. We urge the Board to consider that the external auditor's attestation is not an independent test of management's assessment of internal controls, but rather is part of an integrated review with the financial statement audit, which views internal controls as a network of many procedures and compensating controls.

We would hope that you will take into account the concerns above when you review our list of prioritized concerns on the exposure draft.

Thank you for your consideration and as always, please do not hesitate to contact us for clarification or follow-up questions.

Sincerely,

Adrian Dillon
CFO
Agilent Technologies, Inc.

EXHIBIT A
Selected Responses To PCAOB Questions

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.

No. We do not see a need to devise new measures beyond the existing competence and training standards. As professional firms, external auditors have always been required to be competent in the areas in which they provide services. They should be able to determine the training necessary to execute the attestation in accordance with PCAOB's framework.

Questions regarding evaluation of management's assessment:

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?

We agree that the scope might be appropriate, in that the auditor may need to obtain certain evidence directly. However, the depth and extent of testing suggested is beyond a reasonable cost-benefit to an average shareholder. We urge the Board to allow the external auditors to exercise judgment and utilize their comprehensive audit knowledge about the risks and control environment at each company. The auditors should be able to use discretion to determine the appropriate level of testing required to gain comfort on the internal controls over financial reportings.

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

We believe the guidance is fine, but as stated above, the standard should leave room for the external auditor's professional judgment.

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?

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?

We believe there is value in performing walkthroughs. Wherever possible, walkthroughs should be conducted in conjunction with the financial statement audit. The auditors need to have the freedom to determine what walkthroughs are necessary. They should not be required to perform a walkthrough for every process at every location or site or in future years be required to repeat walkthroughs if those processes have not changed. We also believe that internal audit should be able to participate under the direction of the auditor in these procedures.

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?

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

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?

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)?

With the statement that "the more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be.", the Board has wisely recognized the fiscal benefit to companies of a strong internal audit function. In other portions of the proposed standards, the exposure draft seems to move away from the above statement. While certain sections encourage the use of management, including internal audit, other provisions limit the circumstances in which internal audit may be used. The draft proposes that internal audit cannot be utilized for the following areas:

- Control environment, including fraud controls.
- Controls over period-end financial reporting process.
- Controls that have a pervasive effect on the financial statements, such as certain IT general controls on which the operating effectiveness of other controls depend.
- Walk throughs.

These prohibited functions are some of the key areas in which an internal audit group can provide significant insight and audit evidence based on its experience with the company. Public companies would not expect external auditors to rely solely on internal audit for 100% of testing, but to eliminate internal audit from these critical areas is a dramatic change from present accepted practices. In addition, this proposed point does not allow the external auditors latitude to use their own professional judgment.

We urge the Board to utilize the provisions of Statement of Auditing Standards No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, which address the relationship of the internal audit function in the external audit of financial statements. Rather than redefining this relationship, it would seem that the Board's standard should extrapolate the SAS 65 standards to the audit of internal control over financial reporting especially given that external auditors are now required to perform an integrated audit of financial statements and internal control over financial reporting.

Questions regarding evaluating results:

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?

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?

We appreciate the Board's attention to the importance of clear definitions in the attestation process. However, the exposure draft has dropped the materiality threshold for what is considered to be a significant deficiency or a material weakness. Under the proposed rules, a shortcoming that is neither significant nor material can nevertheless qualify for one of these labels, with serious consequences.

The exposure draft states that a circumstance which creates more than a "remote" likelihood of a misstatement, which is more than "inconsequential" in amount, qualifies as a significant deficiency. The word "inconsequential" is not defined and will likely be interpreted differently. Many companies could point to a control activity failure that has a 10% probability of occurring and involves potential monetary amounts that are 5-10% of what those companies would consider "material." Although the likelihood of such an occurrence is small and the monetary amounts are not material, this, under example D-1, Scenario A, might be a significant deficiency.

If these definitions are retained, we ask the PCAOB to consider and clarify whether the relevant monetary threshold is the dollar impact which could reasonably occur, or the maximum financial impact under a worse case scenario. Currently, the PCAOB proposed definitions would include a number of scenarios from the worst case; ranging from more than remote likelihood with a material impact, to a probable likelihood with a very small impact. Is the intention of the PCAOB to cover this wide range of probability in required disclosures to the audit committee?

A review of the exposure draft examples reveals that the exceedingly low threshold proposed, exponentially increases the risk that companies will trigger multiple significant deficiencies; without regard to any compensating controls. Example D-1, Scenario A on its face seems to be an example of a deficiency, not a significant deficiency, especially given the compensating controls in place to catch material errors. The proposed standard will lead to disclosure of many significant deficiencies which may aggregate to a material weakness judgment and which may cause shareholders and third parties to consider the risk of material misstatement to be much greater than it actually is. This in turn may bring unwarranted volatility in a company's stock price. We are also concerned that the proposed standards will open the door for litigation against companies when an adverse internal control report is issued even though the company's financials are accurate and fairly presented.

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?

No. We believe all substantial and significant deficiencies should be escalated based on the auditor's judgment. By requiring all deficiencies to be reported to management, you have several unintended consequences.

1. This will create debate and animosity between the process owners and the external auditors. There will be great debate on what is a deficiency versus a decision by management to have a higher level compensating control in place to catch material issues or a decision by management that the costs far outweigh any risk of loss or exposure for the company.
2. Companies are not static and systems technology and people change. Companies are continually adapting their controls to their business environment. The proposal to communicate all internal control deficiencies would inundate management, potentially reducing their time to review, or causing them to lose focus on, more significant control issues.
3. With the increased pressure and exposure that audit committees are facing, audit committees will feel obliged to review the list of deficiencies presented to management. This will force audit committees to spend significant time reviewing these deficiencies even though they did not reach the level of a significant deficiency.

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?

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

We believe that more guidance is necessary to understand the extent of the Board's requirements for evaluating the effectiveness of the audit committee. In the infamous Enron audit committee failure, it should have been clear to Enron's external auditors what the relative levels of effectiveness were for each member of the committee. As a result of the PCAOB proposed standards, CPA firms are now planning significant audit procedures -- including lengthy surveys and interviews with the audit committee -- to fulfill the evaluation requirement. In reality, after working with the audit committee for a year, an external auditor should be able to determine rather quickly if the audit committee is effective. The added benefit of surveys and interviews at the end of the year appears to be quite small, while the detriment is a procedural burden for audit committee members whose time is better spent on their other duties. While the ability to oversee the preparation of audited financials and disclosure is a key function of an audit committee, this is not the only role that it plays. We question whether external auditors are the proper arbiters of the overall effectiveness of an audit committee. Ultimately, the company must make that decision. In addition, there is an inherent conflict of interest in asking the external auditors to evaluate the audit committee.

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, we do not believe this would be an appropriate response and believe that this material weakness should be treated no differently than any other identified material weakness.

Dennis M. Stevens
Internal Auditor
Alamo Group
1502 E. Walnut
Seguin, TX 78155
November 4, 2003

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

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

Gentlemen:

I believe compliance with your Proposed Auditing Standard will result in excessive and redundant costs. Adoption of your proposal will immediately place foreign subsidiaries of American businesses at a distinct disadvantage relative to local competitors and hamper the ability of American business to compete globally. It will hinder responsiveness in a rapidly changing business environment. I urge the PCAOB to reconsider the need for the “audit of internal control” mandated by the Proposed Standard and adopt provisions more closely aligned with the report on management’s assessment of internal control required by the Sarbanes-Oxley Act of 2002 (SOX).

The requirements of your Proposed Standard appear to be particularly onerous for the small and medium-sized issuers referenced in your question 4. We for example are a medium-sized manufacturer consisting of several smaller business units operating in six countries. One-on-one training and close supervision are more frequently encountered than user manuals and formal documentation. We have been active in acquiring other companies, many of whom are small, privately held entities that have loose and informal procedures. Our business environment requires that we very carefully watch our head-count, our capital expenditures and virtually all other aspects of the business that require resources.

Our efforts to comply with SOX began over a year ago. A conscious effort was made to ensure we are performing comprehensive quarterly reviews while incurring minimal expense and disruption to our team. We have learned, we have improved, and we expect to continue doing so in the foreseeable future. Into this environment comes your Proposed Standard, which we believe will have the following effects:

1) A substantial increase in annual external audit fees.
2) A substantial increase in expense to prepare user manuals, flowcharts and other types of formal documentation. This is evidently advisable because under the terms of your Proposed Standard “inadequate documentation of the design of controls” is an “internal control deficiency” (page A-43, paragraph 125).
3) A substantial, ongoing increase in expense to change the user manuals and formal documentation mentioned above to reflect changes in systems and procedures as they occur.
4) A substantial increase in expense for management to test and evaluate control procedures relating to “all relevant assertions related to all significant accounts and disclosures” (page A-19, paragraph 41), presumably in all business units and in all countries. We should be happy to do so knowing that the majority of what we do will be disregarded by our auditors and must be repeated by them, since there are a number of significant areas “in which the auditor should not use the results of testing performed by management” (Page A-38, paragraph 104) and, in the end, “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” (page A-39, paragraph 109).

5) Severely constrained and highly impractical timing in finalizing and integrating acquisitions. Presumably deals involving significant acquisition targets having little documentation and substantial room for improvement in controls would have to be either finalized early in the fiscal year or avoided completely. If consummated there will be only a few months to make the substantial changes needed to avoid possible negative disclosures resulting from the annual "audit of internal control". Further, these changes would have to be completed early enough in the year to permit testing of their operating effectiveness.
6) Severely constrained timing and a substantial increase in expense relating to significant system changes and conversions. These too may have to be completed early enough in the fiscal year to permit testing of their operating effectiveness. Each significant system change or conversion could become far more expensive; since related controls typically are regarded as "information technology general controls" and as such are one of those "areas in which the auditor should not use the results of testing performed by management and others".

I do not believe the "audit of internal control" mandated in your Proposed Standard results from a kind of ground swell of investor demand as implied in the first paragraph of page 8. Rather, I note that the approach outlined in your Standard is largely identical to the approach described by the AICPA's Auditing Standards Board in its proposal offered in March 2003. The "audit of internal control" I submit, results more from the profession's concern for protecting itself. That concern is understandable. I suggest a revised proposal along the following lines:

- Define management's responsibilities in performing its assessment of internal control in much the same manner as your paragraph 19 which begins on page A-13;

- Define the auditor's responsibilities in evaluating management's assessment along the lines of paragraph 41. Be specific as practicable and provide criteria the auditor can use to determine if management appears to have satisfied its responsibilities. The end result of the auditor's work should be his or her opinion as to whether management appears to have a reasonable basis for expressing their opinion on internal control. Make clear in the resulting report that internal control and its assessment is a responsibility of management, while the auditor's responsibility is to determine if management had a reasonable basis for their assessment.

- Reconsider the interpretation of SOX Section 103(a)(2)(A)(iii), which heretofore seems to have been construed to require substantial tests of control procedures performed directly by the auditor in conjunction with an "audit of internal control". I believe the public would be better served by a description of the scope of testing performed as part of the integrated audit of the financial statements and management's assessment of internal control. The auditor's report might state for example that his or her tests of internal control were limited to those considered necessary in the circumstances to ensure management had a reasonable basis for their assessment of internal control, ensure receipts and expenditures were being made only in accord with appropriate authorizations, and ensure reasonably accurate and detailed records were being maintained.

- Work to provide the public accounting profession with some form of safe harbor concerning their review of management's assessment of internal control. The auditor's liability should be limited if he or she can show they satisfied the auditor's responsibilities defined by the PCAOB. Limited liability is, in my estimation; preferable to the enormous costs involved in an "audit of internal control."

Management's assessment has value, and the public good is well served by ensuring their assessment has substance. The auditor's attestation on management's assessment can and should be a very different, far more focused service than the broad "audit of internal control" proposed. Please work toward a more cost-effective solution than that described in the Proposed Standard.

Respectfully submitted,

Dennis M. Stevens

From: Barlow_James [Barlow_James@Allergan.com]
Sent: Friday, November 14, 2003 9:02 PM
To: Comments
Subject: Comments For Docket Matter No. 008

November 14, 2004

Office of the Secretary

PCAOB

1666 K Street, N.W.

Washington, D.C. 20006-2803

Regarding: PCAOB Rulemaking Docket Matter No. 008

Dear PCAOB Representative:

I would like to provide the PCAOB with my comments regarding question 17 in the Docket Matter noted above. The question asked is as follows:

17. Will the definition 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?

The answer to the first question is no. The reasons for my answer are described in the answer to the second question noted below.

The answer to the second question is as follows.

The concept of a “significant deficiency” occurring where there is a “more than remote likelihood” involving an amount that is “more than inconsequential in amount” is defined at too low a threshold of possibility and magnitude. Every company has certain critical accounting policies which individually or in combination with other critical accounting policies may actually result in amounts differing from estimated amounts with more than a remote likelihood of occurrence at more than inconsequential amounts. That’s why such policies are listed as critical. Such examples at my company are i) estimated liabilities for managed care sales rebate and other incentive programs, the largest of which relates to Medicaid sales, and ii) income taxes, which includes both current and deferred taxes. Additionally, fair value computations under SFAS No. 123 are inherently inaccurate, but the Financial Accounting Standards Board indicated in its deliberations before adopting SFAS No. 123 that some estimate of value was better than no estimate of value at all. The PCAOB must realize that these amounts are estimated using a SFAS No. 5 concept of “probable” and “reasonably estimable,” which does not require a less than slight chance of being wrong.

The combination of probable and reasonably estimable does not equate to recordation of estimated amounts that can be certified to be accurate to a degree that will not vary by less than an inconsequential amount at a less than a remote likelihood. The concepts are theoretically different. Probable is something akin to 60% to 65% likelihood and remote is akin to less than 5%, or the inverse amount of 95% as to accuracy. As such, these critical policy accounts will always be by definition a significant deficiency, and their effects must always be combined with other accounts to determine if a material weakness occurs in combination with all accounts that are considered significant deficiencies. I believe the threshold for likelihood should be changed to something that is not more than a “possible likelihood,” which I define as something less than a 20% likelihood, which is clearly less than “reasonably possible,” but well above “remote,” as defined by SFAS No. 5.

The PCAOB should also address the following question in this auditing standard. If a company properly identifies for its readers its critical accounting policies and states that the estimated amounts included in the company’s financials have more than a remote likelihood of actually varying by amounts that are more than inconsequential, can those accounts then be considered exempt from combination with other accounts when determining if a material weakness exists when evaluating internal controls over financial reporting? I believe they should be exempt if properly disclosed.

This proposed auditing standard appears to create a sense of utopia in financial reporting. Rhetorically speaking, if every thing in accounting could be recorded with a less than remote likelihood of error at less than inconsequential amounts, we could truly achieve a brave new world in accounting. I don’t believe the economics of business support that possibility, even if a big brother is designated by law to watch over corporate America.

Respectfully,

James F. Barlow

Vice President, Corporate Controller and

Principal Accounting Officer

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Allstate
You're in good hands.

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 No. 008
Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

Dear Secretary:

Thank you for the opportunity to comment on the above referenced Proposed Auditing Standard (Proposed AS) which we believe represents an important step in promoting investor confidence through the effective assessment and reporting on internal controls over financial reporting. While we support your overall efforts concerning this very complex subject, we also appreciate the opportunity to comment on several important areas addressed in the Proposed AS. These areas include certain inconsistencies between the general framework and the Proposed AS, the testing of operational effectiveness, use of the work of management and others, and the definition of a significant deficiency. We urge the Board to carefully consider our comments, which we believe will promote a more efficient, cost-effective, and balanced evaluation of internal controls over financial reporting.

Inconsistencies between the Framework and Proposed AS

The general framework of the Proposed AS appropriately identifies a number of key concepts common to audits and evaluations of internal controls including the following:

- **Auditor's Objective in an Audit of Internal Control Over Financial Reporting**

- *The auditor's objective in an audit of internal control over financial reporting is to form a basis for expressing such an opinion, the auditor must plan and perform the audit to obtain reasonable assurance about whether the company maintained, in all material respects, effective internal control over financial reporting…..*

- *To obtain reasonable assurance, the auditor evaluates the assessment performed by management and obtains and evaluates evidence about whether the internal control over financial reporting is designed and operated effectively…..*

- **Inherent Limitations in Internal Control Over Financial Reporting**

- *Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations…..*

- **Reasonable Assurance**

- *Management's assessment of the effectiveness of internal control over financial reporting is expressed at the level of reasonable assurance. The concept of reasonable assurance is built into the definition of internal control over financial reporting and also is integral to the* *auditor's opinion. Reasonable assurance includes the understanding that there is a relatively low risk that material misstatements will not be prevented or detected on a timely basis. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance.*

- **Materiality Considerations in an Audit of Internal Control Over Financial Reporting**

- *The auditor should apply the concept of materiality in an audit of internal control over financial reporting at both the financial-statements level and at the individual account-balance level……*

- *The same conceptual definition of materiality that applies to financial reporting applies to information on internal control over financial reporting, including the relevance of both quantitative and qualitative considerations.*

Despite recognition of the key concepts of reasonable assurance, inherent limitations, and materiality in the general framework of the Proposed AS, the Proposed Standard itself abandons these critical concepts through the inappropriate use of words such as "all", "each," and "entire". We believe that through the use of these "all inclusive" words the Proposed AS directly contradicts the basic notion of reasonable assurance, inherent limitations, and materiality and in so doing sets an unattainable standard for both the registrant and the independent auditors in carrying out their responsibilities under the Proposed AS. More specifically, we do not believe it would be either cost-beneficial or possible to document, test, and attest to the effectiveness of "all" or "each" control within the "entire" internal control over financial reporting system as could reasonably be construed by the language in the Proposed AS. It is our assumption that the use of words such as "all", "each", and "entire" was unintended as it is inconsistent with the PCAOB's recognition in it's general framework that there are inherent limitations in any internal control system such that obtaining "absolute assurance" of its effectiveness cannot be obtained. Moreover, we believe the PCAOB recognized that fact when it suggested that when testing internal controls over financial reporting the tests should be designed to obtain "reasonable assurance" that the controls are operating effectively. Although the term "reasonable assurance" is not adequately defined in either the Proposed AS or related literature, it is our understanding that it has historically incorporated judgment and an assessment of materiality in designing tests to meet the "reasonable assurance" threshold which is definitively different than the "absolute assurance" threshold implied by the use of words such as "all", "each," and "entire". Accordingly, we strongly suggest eliminating words such as "all", "each," and "entire" in the Proposed AS as they suggest the imposition of a level of review and testing that is neither cost-beneficial or possible.

Testing Operating Effectiveness

Question 11:

Is it appropriate to require the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year or may the auditor use some of the audit evidence obtained in previous years to support his or her current opinion on management's assessment?

We believe the independent auditor should apply their judgment and place appropriate reliance on their previous experience within the industry and with the registrant when determining the evidence necessary to support their opinion on management's assessment of internal controls over financial reporting. We believe the independent auditor's knowledge and understanding of a registrant's internal control structure is enhanced with experience as many components within a company's internal control structure do not change significantly from year to year. Accordingly, the independent auditor should be permitted to appropriately leverage this experience and modify the timing and extent of internal control testing aimed at determining whether controls over financial reporting are appropriately designed and operating effectively. Assuming the preceding, the independent auditor would appropriately focus their substantive tests on areas within the registrant's internal control structure that have changed.

Use of the Work of Management and Others

The Proposed AS summary suggests that the work performed by management in connection with its assessment of internal controls over financial reporting can have a significant effect on the nature, timing and extent of the work performed by the independent auditor, however, the Proposed AS does not appear to support this statement given its restrictions on the use of the work of management and internal auditors.

Question 13:

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

We believe the complete restriction placed on the use of the results of testing performed by management and internal auditors is inappropriate and severely limits the independent auditor's ability to appropriately alter the nature, timing and extent of their substantive tests. While we generally understand the Board's attempt to identify more critical areas for the independent auditors in the current business environment, we believe the work of management and internal auditors should not be ignored when determining the nature, extent and timing of substantive audit procedures. We believe that to the extent the independent auditor's consideration of work completed by internal auditors expressly considers their independence, approach, and competence there is no reason their work should not be relied on. The same approach should be applied to the work of management, not withstanding their lack of independence.

Question 9:

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

We believe walkthroughs would be very time-consuming and costly for the independent auditors to complete for each of the registrant's significant processes. Moreover, the independent auditor's primary focus should be on evaluating the design and operational effectiveness of internal controls over financial reporting. In contrast, documenting internal controls over financial reporting is typically completed by management and internal auditors. Furthermore, as noted above in our response to question 11, requiring auditors to perform walkthroughs each year does not appropriately consider the independent auditors previous experience and knowledge of the industry or the registrant. Assuming documentation supporting the control environment already exists, we believe the independent auditor should only perform walkthroughs of significant processes on a limited test basis applying their judgment by taking into account their previous experience with the industry and with the registrant to validate their understanding of the process as documented by management and the internal auditors.

Question 14:

Does the proposed standard give appropriate recognition to the work of internal auditors? If not, does the proposed standard place too much emphasis and preference on the work of internal auditors or not enough?

We believe the Proposed AS does not appropriately leverage the work completed by internal auditors. The Proposed AS would require significant duplication of work and inefficiencies resulting in a higher cost of performing substantive tests by the independent auditors. Accordingly, we believe the Proposed AS should consider the outcome of the required assessment of the competence and objectivity of the internal auditors as outlined in AU § 322 and allow the independent auditors to apply an appropriate level of reliance on the work of internal auditors. AU § 322 requires the independent auditor to obtain information on the educational level and professional experience of internal auditors (including professional certifications and continuing education), audit policies, audit programs and procedures, practices regarding assignment of internal auditors, supervision and review of internal auditors' activities, quality of working-paper documentation, reports and recommendations, an evaluation of internal auditors' performance, and consideration of the organizational status of the internal auditors. We believe that, depending on the outcome of this comprehensive review, the independent auditors should be allowed to rely on the work of internal auditors.

Significant Deficiency Definition

Question 17:

Will the definitions in the proposed standard of a significant deficiency and material weakness provide for increased consistency in the evaluation of deficiencies? How can the definitions be improved?

We believe the definition of a significant deficiency in the Proposed AS is ambiguous, would be difficult to apply, and therefore would not provide for increased consistency in the evaluation of deficiencies (both individually and collectively). To improve upon the definition in the Proposed AS we believe the PCAOB should incorporate specific evaluative criteria into the definition against which reporting entities could easily and consistently evaluate deficiencies in internal controls over financial reporting. Moreover, we believe the evaluation criteria should give due consideration to both the nature and the actual (or potential) materiality of the item in relation to the annual or interim financial statements to which they (it) relate(s).

The definition in the Proposed AS of a significant deficiency in internal controls over financial reporting is as follows:

> *A significant deficiency is an internal control deficiency that adversely affects a reporting entity's ability to initiate, record, process, or report external financial data reliably in accordance with generally accepted accounting principles. A significant deficiency is a deficiency that, by itself or a combination of deficiencies, results in more than a remote likelihood of a misstatement of the annual or interim financial statements that is more than inconsequential in amount and would not be prevented or detected.*

We do not believe the term "more than a remote likelihood of a misstatement of the annual or interim financial statements that is more than inconsequential" provides clear, objective criteria against which one can easily and consistently evaluate deficiencies in internal control over financial reporting. More specifically, we believe that without evaluative criteria against which to evaluate deficiencies, reporting entities will interpret and apply the terms "more than a remote likelihood" and "more than inconsequential" in an inconsistent manner. Moreover, when developing the evaluative criteria we suggest that certain concepts be incorporated to eliminate the potential that minor deficiencies, that exist in even the most well-controlled business environments, are not inappropriately designated as significant deficiencies as that could have the unintended consequence of de-sensitizing relevant parties (i.e. financial statement preparers, users, and independent auditors) to the importance of significant deficiencies.

To ensure that deficiencies (both individually and collectively) are consistently evaluated against a set of objective criteria designed to identify only those individual and collective deficiencies that warrant designation as a significant deficiency we propose the following definition and set of evaluative criteria:

Proposed Definition – Significant Deficiency

> *A significant deficiency is a deficiency in internal controls over financial reporting that adversely affects a reporting entity's ability to initiate, record, process, or report external financial data reliably in accordance with generally accepted accounting principles. A significant deficiency is a deficiency that, by itself or in combination with other deficiencies, results in the reasonable possibility of a misstatement of the annual or interim financial statements that would not be prevented or detected and that by its nature or amount, represents a misstatement that would affect the judgments of a reasonable investor or creditor.*

Proposed Evaluative Criteria – Nature of the Deficiency

When evaluating the nature of a deficiency (or combination of deficiencies) in internal controls over financial reporting the following factors should be considered:

- Whether the related actual (or potential) misstatement arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate;
- Whether the related actual (or potential) misstatement masks a change in earnings or other trends;
- Whether the related actual (or potential) misstatement changes a loss into income or vice versa; and
- Whether the related actual (or potential) misstatement involves concealment of an unlawful transaction.

Proposed Evaluative Criteria – Actual or Potential Significance of the Deficiency

When evaluating the significance of a deficiency (or combination of deficiencies) the following criteria should be used as a guide to determine whether the deficiency (or combination of deficiencies) is significant (or has the potential to become significant) as it relates to the annual or interim financial statements of the relevant registrant:

- Does the deficiency (or combination of deficiencies) concern information related to the registrant that would cause a reasonable investor to make a different decision with regard to the purchase of the registrant's securities (either debt or equity)?
  - Does the deficiency (or combination of deficiencies) significantly affect the reported earnings or financial strength ratings of the registrant? A deficiency affecting reported earnings but not the financial strength of the registrant may not affect the investing decisions of a holder of the registrant's debt securities.
- Are the financial statements filed by the registrant for a specific purpose (e.g. are they required to support the issuance of certain products – e.g. variable insurance policies)?
  - If so consider how the purchasers of those products would view the deficiency in light of what information they consider important to their investment decision.
- Determine whether the deficiency (or combination of deficiencies) could significantly affect the registrant's financial strength ratings.
  - Does the deficiency significantly affect the registrant's regulatory capital ratios, if any?
  - Does the deficiency significantly affect the registrant's asset/liability management, asset quality, liability duration, or key financial strength measures?
  - Does the deficiency (or combination of deficiencies) significantly affect the run-rate of the registrant's business operations?

I can be reached at (847) 402-2213 if you would like to discuss the contents of this letter.

Sincerely,

Samuel H. Pilch

Samuel H. Pilch
Controller
The Allstate Corporation

AMERADA HESS CORPORATION

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NEW YORK, NY 10036

November 21, 2003

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

Re: PCAOB Rulemaking Docket Matter No. 008

Dear Ladies and Gentlemen:

We are pleased to respond to the proposed auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements.* Amerada Hess Corporation (the Corporation) is a global, independent energy company with worldwide exploration and production activities and domestic refining and marketing operations.

Specific responses to certain of the Board's questions are attached in Appendix 1. Our responses are keyed to the numbered question in the request for public comment. We agree with the proposed auditing standard as drafted for those areas where we have not responded to one of the Board's questions. Provided below are general observations on the proposed auditing standard:

- We believe the proposed auditing standard requires duplication of work by an independent auditor and management not contemplated by Congress when it passed Section 404(b) which requires an independent auditor to attest to, and report on, the assessment made by management of the issuer. We believe there is a difference in the elements of work that management must do to establish and report on processes and controls and the work done by the independent auditor when attesting to management's assessment.

  The proposed auditing standard provides significant guidance for auditors in determining the scope of work necessary to support the required attestation. The guidance for management's assessment seems to create a duplication of work. The proposed standard appears to not only require management to document all significant processes and controls and perform walkthroughs but also requires management tests of all key controls to support its assessment. The auditor is required to review management's documentation of significant processes and controls, perform independent walkthroughs and perform similar tests of all key controls to support the auditor's conclusion. We do not believe the standard should require management and its auditor to perform similar testing on all key controls. While this duplication adds costs it does not seem to add additional support to the auditor's attestation. This duplication appears inconsistent with the Section 404 (b) requirement to have auditors attest only to management's assessment. We understand the Board's desire to have an integrated audit and have separate audit opinions for the financial statements and the internal controls over financial reporting. We therefore believe the testing of key controls should be performed solely by the auditor in accordance with requirements established in the auditing standard. Guidance for management's evaluation of the effectiveness of internal control should exclude the need for duplicate testing. Management should be required to design effective control processes, including monitoring controls, document all significant processes and controls and the effectiveness of controls should be evaluated solely by the performance of a walkthrough and the ongoing daily or periodic monitoring of the processes.

- If the proposed auditing standard is adopting substantially in its current form to require duplicate testing by management and the auditor, the requirement for the independent auditor to obtain sufficient evidence about the design and operating effectiveness of controls related to all financial statement assertions for all significant accounts and disclosures in the financial statements will cost significantly more than the benefit gained by implementing such a standard. We believe the independent auditor should be able to use professional judgment when determining the scope of work in an audit of internal control over financial reporting. Specifically, we believe the final auditing standard should permit the independent auditor to rely to a greater extent on work performed by internal audit and others and the outcome of procedures performed in conjunction with the audit of the financial statements, particularly in the areas of disclosures, significant estimates and significant non-routine transactions.

- We believe the independent auditor should not be required to evaluate the effectiveness of the audit committee. Rather we believe the independent auditor should consider its view of the audit committee's effectiveness when determining the scope of work in an audit of internal control over financial reporting.

* * * * * * *

Thank you for considering our views. We would be pleased to answer any questions or discuss these issues further. I can be reached at (212) 536-8550.

Very truly yours,

/s/ John Y. Schreyer

John Y. Schreyer
Executive Vice President
and Chief Financial Officer

Appendix 1

Responses to Questions

We have responded to questions 6, 12, 13, 14, and 15 assuming the proposed auditing standard is adapting substantially in its current form to require duplicate testing by management and the auditors.

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?

   If the final standard requires an audit of internal control over financial reporting, we believe the independent auditor should have the ability to exercise professional judgment when determining the extent of direct evidence necessary regarding the design and operating effectiveness of controls related to all financial statement assertions for all significant accounts and disclosures in the financial statements.

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?

   We believe inadequate documentation should not automatically rise to the level of significant deficiency or material weakness. The focus should be on the existence of effective operating controls. Documentation by itself does not contribute to the prevention or detection of material misstatements in the financial statements.

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?

    We believe the independent auditor should be able to rely on walkthrough procedures performed by internal audit, and in limited circumstances, management.

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?

    We do not believe it is necessary to obtain evidence for all relevant assertions for all significant accounts and disclosures every year. Evidence obtained in prior years plus the outcome of procedures performed in conjunction with the audit of the financial statements should be considered in determining the level of work to render an opinion on internal control over financial reporting.

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

    We believe auditor judgment should determine the extent to which the work of others is relied upon. Factors to consider include the quality of the control environment and the competency and independence of the individuals performing the work.

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

    We agree with the three categories of controls. However, we do not believe it is cost effective to require management and the independent auditor to separately test IT general controls every year.

14. <u>Does the proposed standard give appropriate recognition to the work of internal auditors? If not, does the proposed standard place too much emphasis and preference on the work of internal auditors or not enough?</u>

    We believe the proposed standard does not give enough recognition to the work of internal audit. The independent auditor should assess the capabilities and independence of internal audit in determining the level of reliance to be placed on internal audit's work.

15. <u>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)?</u>

    We believe the independent auditor should use professional judgment in determining the extent of reperformance of work performed by others.

18. <u>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?</u>

    We do not believe the examples in Appendix D provide helpful guidance. We believe management and its auditor should determine if a deficiency is a significant deficiency or a material weakness using the definitions provided in paragraphs 7 through 9. These definitions should be applied to the specific facts and circumstances of the individual deficiency. We appreciate the Board's desire to provide additional guidance, however we believe the use of the limited fact patterns in the examples may create inappropriate minimum thresholds for significant deficiencies and/or material weaknesses.

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?

As stated in our opening comments, we do not believe it is appropriate to require the independent auditor to evaluate the effectiveness of the audit committee due to the inherent conflict of interest caused by the audit committee's role to hire, fire and set the fees for the independent auditor.

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?

We do not believe the standard should require the auditor to withdraw from the engagement in that situation, although the auditor may choose to do so.

America's Community Bankers Shaping Our Future

November 21, 2003

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

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

Dear Sir or Madam:

America's Community Bankers ("ACB")[1] is pleased to comment on the proposed auditing standard for attestation engagements required by Section 404(b) and Section 103(a)(2)(A) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") issued by the Public Company Accounting Oversight Board "PCAOB".[2]

Sarbanes-Oxley was passed to strengthen public company corporate governance and financial disclosure in an effort to restore investor confidence in the public markets. To further the public interest in the preparation of complete and accurate public company audit reports, Sarbanes-Oxley mandated the creation of the ("PCAOB") to oversee and regulate the public company auditing profession. The proposed standard would establish professional guidelines to govern the independent auditor's attestation of and reporting on management's assessment of the effectiveness of internal control over financial reporting.

[1] America's Community Bankers represents the nation's community banks. ACB members, whose aggregate assets total more than $1 trillion, pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities.
[2] Pub. L. 107-204 (2002).

ACB Position

The PCAOB's proposed auditing standard would add burdensome, conflicting, and overlapping requirements on community banks. ACB believes that section 404 was meant to mirror the similar requirements imposed on financial institutions by the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA").[3] FDICIA, which has been in place for 12 years, requires management of depository institutions with $500 million or more in assets to assess the effectiveness of the institution's internal control structure.[4] The institution's independent public accountant must examine, attest to, and report separately on, management's assessment. The federal banking regulators have never interpreted this legislative language to require an independent audit of the effectiveness of the internal control structure, as is being proposed by the PCAOB. Congress was aware of the process used to comply with FDICIA, but still adopted almost identical language in section 404(b) of Sarbanes-Oxley to describe the responsibility of the public auditor.

We believe that the PCAOB should conform the standard to the requirement mandated by Congress by requiring an attestation only of management's assessment of the internal control structure to avoid duplication of work and unnecessary expense. If the PCAOB adopts the proposal to require an audit of internal control over financial reporting, the PCAOB should exempt from that requirement insured depository institutions that are regularly examined and subject to continuing supervision by federal banking regulators. The PCAOB should recognize the significant and substantial protections afforded to depositors and investors by the banking laws and establish a standard for depository institutions that mirrors the standard in FDICIA that only requires an attestation of management's evaluation of internal control over financial reporting.

ACB also has concerns with the following provisions of the proposal:

- The requirement that the auditor conduct evaluations of the internal control structure over financial reporting be conducted on a *quarterly* basis.
- The requirement that the external auditor evaluate the effectiveness of the audit committee's oversight of the company's financial reporting and internal control structure.
- The requirement that the external auditor limit the use of testing performed by management and others in a number of areas.
- The lack of adequate guidance regarding attestation procedures for small and medium-size businesses.

Attestation of Management's Assessment of Internal Control

In its proposed auditing standard, the PCAOB proposes to adopt an unnecessary and significantly expanded interpretation of the Sarbanes-Oxley requirements. Two sections of Sarbanes-Oxley

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[3] Pub. L. 102-242 (1991).
[4] 12 U.S.C. § 1831m and 12 C.F.R. Part 363.

address the attestation of management's assessment of the internal control structure. Section 103(a)(2)(A) stipulates that the PCAOB develop an auditing standard that would require the external auditor to "*describe in each audit report the scope of the auditor's testing of the internal control structure and procedures of the issuer, required by section 404(b)*…." Following this wording, Section 404(b) of Sarbanes-Oxley directs public company auditors to "*attest to, and report on, the assessment made by management*." However, the PCAOB is proposing that the auditor perform a detailed integrated audit of internal control and financial statements and opine directly on the effectiveness of internal controls.

An attestation traditionally refers to a process in which the auditor provides a conclusion about the reliability of management's written assertion, while an audit traditionally involves examination of the financial statements. There is a very distinct difference between the two that was recognized by Congress. Requiring an independent audit of internal control over financial reporting will be duplicative of work performed by a company's internal audit function and senior management and will ultimately be very costly and burdensome. Public company auditors will interpret their responsibilities under the standard quite broadly and, in an effort to avoid future liability, will err on the side of doing too much, rather than not doing enough. This would be understandable in light of recent corporate scandals and the collapse of Arthur Andersen. However, the public auditors will be adequately compensated for this work at a significant cost to public companies and their shareholders.

We urge the PCAOB to reconsider whether a separate audit of internal controls is really necessary and scale back these standards to a reasonable level of inquiry that allows an auditor to opine on the conclusions reached by management. There are other requirements recently put in place that will protect the investing public and that make a more burdensome standard inappropriate. For instance, the chief executive officer and chief financial officer must certify each quarter as to the accuracy of the company's financial statements and their responsibility for establishing and maintaining internal controls.[5] They also must certify that the internal controls have been designed to provide reasonable assurance about the reliability of the financial statements and that they have evaluated the effectiveness of the internal controls. The certifications with regard to the compliance of the periodic filing with the Securities Exchange Act of 1934 are made under the threat of criminal liability if the officer knowingly makes a false certification.

ACB believes that the standard adopted by the banking regulators under FDICIA of requiring an attestation of management's assessment of internal controls, as provided for in section 36 of the Federal Deposit Insurance Act and implemented by Part 363 of the Federal Deposit Insurance Corporation,[6] should be adopted as the standard under the plain language of section 404(b) of Sarbanes-Oxley. If the PCAOB does not believe that this standard is appropriate for all public companies, it should at least acknowledge the comprehensive scheme of regulation and examination that governs depository institutions and their holding companies and exempt these institutions and holding companies from the more burdensome requirement of an independent internal control audit. Insured depository institutions are required to have internal controls,

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[5] Sections 302 and 906 of Sarbanes-Oxley; Final Rule: Certification of Disclosure in Companies' Quarterly and Annual Reports, 67 Fed. Reg. 57276 (Sept. 9, 2003).
[6] 12 U.S.C. § 1831m and 12 C.F.R. Part 363.

information systems and an internal audit function adequate and appropriate for the institution's size and the nature and scope of its activities.[7] An institution's compliance with these safety and soundness requirements is subject to regular examinations by the federal bank regulators.[8]

Quarterly Reviews

The proposed standard outlines some responsibilities that the auditor would have for evaluating management's section 302 disclosures about internal control over financial reporting. ACB opposes the requirement that the auditor perform limited procedures on a quarterly basis to confirm that management's disclosures are complete. Quarterly evaluations are not mandated by Sarbanes-Oxley. Section 404 of Sarbanes-Oxley requires that annual reports include an internal control report and that the independent auditor attest to, and report on, this annual assessment. ACB believes that quarterly evaluations would be impractical, time-consuming, and costly. The experience of the banking industry under FDICIA has shown that an annual auditor review of management's evaluation of internal controls is quite adequate.

Evaluation of the Audit Committee

The proposed standard would require the independent auditor to evaluate the effectiveness of the audit committee's oversight of the company's financial reporting and internal control over financial reporting. This would create serious conflict of interest issues for the auditor and the audit committee. Among the most important goals of Sarbanes-Oxley was to strengthen the role of the audit committee in overseeing the auditor. The audit committee is now specifically responsible for hiring and compensating the external auditor. The proposed requirement will, in effect, dilute the power of the audit committee and may lead to inadequate oversight in an effort to ensure a satisfactory evaluation. The auditor, on the other hand, may be reluctant to issue a harsh evaluation of the committee that is responsible for his or her hiring and compensation. Furthermore, there are no objective criteria or adequate guidelines for the auditor to use to evaluate the audit committee. The evaluation would be completely subjective and based on each auditor's opinions and beliefs on how an audit committee should function. We believe that the review of the effectiveness of the audit committee, at least for regulated financial institutions, is more properly left to the federal banking agencies.

Reliance on the Work of Others

The proposed standard addresses the auditor's use of testing performed by management and others and limits this use in a number of areas, including controls over the period-end financial reporting process and certain information technology general controls. The inability to use the testing performed by management to the fullest extent possible, together with requiring the auditor to conduct walkthroughs of the company's significant processes, would result in unnecessary cost and burden. The external auditor's responsibility should be to obtain a thorough understanding of the processes in place and evaluate if, and to what extent, he or she

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[7] 12 U.S.C. § 1831p-1; 12 C.F.R. Parts 30, 364, and 570, and Appendix D-1 to Part 208.
[8] *See*, for example, section 355 of the Office of Thrift Supervision's *Thrift Activities Handbook*, available at www.ots.treas.gov

can rely on the work performed by management and others by considering the factors discussed in paragraph 103 of the standard. The company's professional and independent audit staff, especially in the highly technical areas like IT controls, may be better suited than the external auditor to understand the internal accounting controls and how they perform. The external auditor's task should be to determine whether he or she can rely on the work performed by the company's professional staff.

If a walkthrough has been sufficiently performed and documented by the company's internal auditors, there is no reason for duplicating their work. This is particularly true in the case of financial institutions, which are required by banking law and regulation to have an internal audit function and that function is evaluated during safety and soundness examinations. The PCAOB itself acknowledges the importance of internal audit by indicating in paragraph 108 of the standard that the auditor may be able to use the results of procedures conducted by internal auditors to a greater extent than the results of procedures performed by others.

Guidance for Small and Medium-Size Companies

ACB is particularly concerned about the effect of the proposed auditing standard on small and medium-sized community banks. The PCAOB states that it is sensitive to the possible effects of the auditing standard on small and medium-size businesses. However, the PCAOB does not offer any specific examples that might serve as guidelines for reviewing internal controls for these companies. The external auditor is left to decide what constitutes an acceptable review and will most likely take a conservative approach. The PCAOB also does not indicate what constitutes a small or medium-size company.

The PCAOB should provide more specific guidance to auditors in evaluating internal controls at small and medium-size companies. As a preliminary matter, the PCAOB should define these companies. An approach would be to define these companies as those that are not considered "accelerated filers" under the rules of the Securities and Exchange Commission ("SEC"). The SEC defines an accelerated filer as a company that (i) has a common equity public float of at least $75 million; (ii) has been subject to the reporting requirements of the Securities Exchange Act for a period of at least 12 months; and (iii) has filed at least one annual report as a public company.[9]

Small and medium-sized businesses will find the extensive walkthroughs, quarterly evaluations, and other requirements in the proposed standard to be prohibitively burdensome and costly. This is especially true for small community banks, which, in addition to the lack of resources that larger banks possess, might not have ready access to auditors experienced in attestation procedures. The requirements would only add to already increasing costs and would likely decrease the competitiveness of these institutions. The PCAOB should provide specific examples of how the external auditor should address the issues particular to small and medium-size businesses and how the attestation process for those companies would differ from that used for larger companies. For example, the requirements for the walkthroughs could be scaled back and the auditor could be given more leeway to rely on the testing performed by management.

[9] 17 C.F.R. § 240.12b-2.

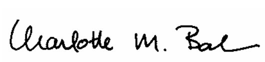
Also, the PCAOB could provide guidance on the review that is expected when there cannot be complete segregation of duties because of the limited staff resources at many smaller companies. While we appreciate the PCAOB's efforts to recognize the special circumstances of small and medium-size companies, more specific guidance in this area is needed to limit the cost and burden of the attestation for community banks.

Conclusion

ACB believes that many aspects of the proposed standard would be unnecessarily costly and burdensome. The standard goes beyond what is required by Sarbanes-Oxley by requiring an integrated audit of internal control and financial statements. Quarterly evaluations and limits on the use of testing performed by others will multiply the cost of the audit and the requirement to evaluate the audit committee will create conflicts of interest. If the PCAOB adopts the standard as proposed, exceptions should be made for depository institutions in light of the existing substantial oversight of those institutions by federal banking agencies.

ACB appreciates the invitation to comment on this issue. If you have any questions about our comments, please do not hesitate to contact me. You can also contact ACB's Senior Regulatory Counsel, Diane Koonjy, at (202) 857-3144 or via e-mail at dkoonjy@acbankers.org, and Accounting and Financial Management Specialist, Dusan Jovanovic at (202) 857-3158, or via e-mail at djovanovic@acbankers.org.

Sincerely,



Charlotte M. Bahin
Senior Vice President, Regulatory Affairs

American Accounting Association ♦ Auditing Section
Auditing Standards Committee

November 17, 2003

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

RE: Invitation to Comment on PCAOB Rulemaking Docket Matter No. 008

Dear PCAOB:

The Auditing Standards Committee (ASC) of the Auditing Section of the American Accounting Association welcomes the opportunity to comment on the proposed auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With An Audit of Financial Statements*. Overall, we believe that the proposed auditing standard is very clear and quite sound in its logic and requirements. We commend the PCAOB for its thoughtful consideration of the many issues involved in reporting on internal control.

The comments below are organized around the 31 questions posed in Release No. 2003-017. We conclude with other comments that are not directly tied to the questions posed.

We particularly call your attention to the following issues, as they reflect our most substantive suggestions:

- Controls in smaller companies (question 4)
- Reliance on the work of others (question 13)
- Definition of significant deficiency and material weakness (question 17)
- Evaluating the audit committee’s oversight (questions 22-24)
- “Except for” opinions (question 26)
- Controls over quarterly reports (question 31)
- The definition of internal control over financial reporting (other comment #1)
- Heavy focus on control activities (other comment #2).

No.	Question Topic	Response
1	Use of "audit of internal control over financial reporting"	Based on the content of the proposed standard, we believe that this terminology appropriately conveys the nature of the auditor's work. However, we do believe that it is important to prominently highlight that the auditor is attesting to management's assertion about internal control effectiveness. If this notion is not prominently highlighted, we believe that there is the potential for an expectation gap to be created (e.g., some may believe that the auditor is almost solely responsible for statements regarding the company's internal control over financial reporting).
2	Prohibiting internal control audit in absence of financial statement audit	We believe that it is appropriate to require the auditor performing an internal control audit also to perform the financial statement audit. The knowledge gained in the financial statement audit is a key input to the internal control audit.
3	Requiring only work *comparable* to a financial statement audit	We prefer the requirement that the auditor actually perform the financial statement audit, as this will better ensure that the auditor has more complete information about the quality of the company's financial statements and disclosures.
4	Internal control in small companies	We have significant concerns with the discussion of internal control in smaller public companies. Research (see Beasley, Carcello, and Hermanson, *Fraudulent Financial Reporting: 1987-1997, An Analysis of U.S. Public Companies*, COSO, 1999) indicates that financial statement fraud among U.S. public companies is concentrated among smaller companies, those with assets and revenues under $100 million. In addition, in over 80% of public company fraud cases, the CEO and/or CFO were implicated in the fraud. However, a pervasive theme of the discussion in the proposed standard is that oversight by ethical top managers may reduce the need for "elaborate internal control systems" in smaller companies. Since small-company accounting fraud typically is perpetrated by CEOs and CFOs, we are concerned that executive-level oversight in such organizations may provide very little protection and may give auditors a false sense of security. In a sense, to prevent fraud, the auditor would be relying on the oversight of the most likely perpetrators. As a result, we question the extent to which executive-level oversight can be an effective substitute for more traditional internal controls. On a related note, if an auditor were to conclude that ethical, executive-level oversight was an appropriate substitute for more extensive internal control systems in a small company, we believe that

		it would be imperative for the auditor to perform significant procedures to assess the ethical orientation of the executives. In the absence of a specific requirement along these lines, we are concerned that many auditors may be inclined to simply state that their small audit clients have effective controls because the CEO and/or CFO are keeping a close eye on the day-to-day operations – without any formal assessment of whether it is reasonable to rely on the oversight of these individuals. We recognize that there are requirements to evaluate the control environment, but we suggest being quite explicit about the auditor's responsibility for assessing top management integrity and values in cases where management oversight is being viewed as an effective form of internal control. Overall, given the concentration of fraud in smaller public companies (and apparently committed largely by CEOs and CFOs), we would strongly prefer to see more focus on formal internal controls in smaller companies. This focus on small company internal controls would be consistent with the SEC's and stock exchanges' decision ultimately to extend recent audit committee reforms to most public companies, rather than exempting those companies with market capitalizations under $200 million.
5	Specifying level of competence and training	We believe that a general statement about the level of competence and training would be appropriate. We recommend including language such as "sufficiently" trained and experienced within the body of the standard. Given that the PCAOB conducts quality reviews of registered firms, we recommend avoiding specific guidelines and instead recommend that the Board focus on competence and training in its quality control efforts.
6	Scope of audit of internal control	We agree with the proposed scope of the audit of internal controls. We believe that it is important for the auditor to obtain direct evidence on the effectiveness of internal controls in addition to evaluating management's assessment method.
7	Criteria for evaluating management documentation	We believe that it is appropriate to provide criteria for evaluating management's internal control documentation. Sound documentation is the first step to understanding controls and ultimately assessing their effectiveness. We do encourage the Board to provide examples that auditors could refer to when evaluating management's documentation.

8	Inadequate documentation as deficiency, significant deficiency, or material weakness	We appreciate the need for auditor judgment in this area and do not believe that inadequate documentation should automatically rise to the level of a significant deficiency or material weakness. Inadequate documentation, and the deficiencies associated with it, should be assessed on a case-by-case basis by the auditor. As a practical matter, we believe that inadequate documentation, in many cases, will rise to at least the level of a significant deficiency. If the controls are not properly documented (i.e., not properly understood by management), then it seems there would be at least "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."
9	Requiring walkthroughs	We strongly agree with the requirement regarding walkthroughs. However, it would be helpful to provide more guidance about the extent of walkthroughs. For example, is one walkthrough for each significant process sufficient (see paragraphs 79-83)? Also, additional guidance on how to perform walkthroughs for control environment issues would be helpful. Finally, we suggest including more explicit language regarding where walkthroughs should begin. Because many information systems at public companies are interconnected and driven by relational databases, identifying the starting point might be difficult. We are concerned that auditors will start the walkthrough at the point where traditional accounting transactions begin, without moving backwards in the process to where the transaction is first initiated. As an example of the complexities involved, under many of the strategic alliance agreements that exist, companies interface their information systems such that transactions initiate at another entity. In such cases, we suggest requiring auditors to begin walkthroughs at alliance partner locations when necessary to understand relevant controls that impact financial reporting.
10	Requiring walkthroughs to be performed by auditor himself or herself	We agree with requiring the auditor to perform the walkthrough himself or herself.

11	Obtaining evidence of control effectiveness each year versus using prior year evidence to support current year conclusion	We agree that "each year's audit must stand on its own." Information from prior-year audits (particularly related to control design) may be an important input into the current year audit, but we do not believe that it can provide the basis for the current year opinion. The same is true for financial statement audits – last year's substantive testing of Accounts Receivable does not allow the auditor to skip Accounts Receivable this year. However, the extent of evidence needed should be reduced if the auditor is comfortable that no significant changes occurred in the design or implementation of a control from a prior year. Finally, we are unclear about the substance of the change to "relevant assertions" from "significant controls" and how this resolves the "so-called 'rotating tests of controls' issue." We suggest that the Board more clearly explain this issue.
12	Using the work of management or others	We do not believe that the auditor ever should be required to use the work of others, and we believe that reliance on such work should always be permitted (although the extent of reliance may be required to vary – see question 13 below). We encourage the Board to consider more carefully defining what constitutes the work of management and others, including a listing of "other" parties who may be considered appropriate.
13	Appropriateness of three categories of controls and extent of auditor reliance on others	The three-tiered approach described in the standard (i.e., controls for which auditor cannot rely, controls for which auditor's reliance is limited, and controls for which auditors can rely) generally seems appropriate. However, we are not fully supportive of having a no reliance category. We understand that some controls (like those in the control environment) are critical. However, even for these critical controls, we believe that the auditor should be able to gain some assurance from work performed by management/internal audit. Granted, the external auditor would need to carefully limit reliance in these areas, but should not be completely prohibited from some degree of reliance. Further, we wonder whether it makes sense to discuss the reliance issue from the perspective of the work performed at interim vs. the "as of" date. For example, to what extent can an auditor rely on interim work by others that is supplemented with the auditor's own work at year-end?
14	Appropriateness of recognition of internal audit work	We believe that the recognition of internal audit is adequate. However, as indicated above, we do not believe it is appropriate to completely prohibit reliance on internal audit's work in some areas, if in fact they have met the quality standards put forth in SAS No. 65.

15	Appropriateness of flexibility in determining reperformance of others' testing	Overall, allowing flexibility in determining the extent of reperformance seems appropriate. Using professional judgment, auditors should be able to decide how much work to reperform, and the conditions under which they should reperform the work. Further, this flexibility should be helpful in terms of concerns about fraud detection – if reperformance is "random" or based on auditors' perceptions about client risk or internal control weaknesses, then there is more of a "surprise" element to the internal control audit, which we believe is appropriate. Having said this, we note that an earlier report by the POB suggested that the level of testing of internal auditors' work when relied upon in a financial statement audit was inadequate in many of the audits they reviewed. Without being specific as to testing requirements (e.g., reperform some tests of all significant accounts) we have some concern that reperformance levels may be too low. We encourage the Board to rely on its quality reviews of registered firms to assess the sufficiency of reperformance and to provide more specific guidance if needed.
16	Auditor obtaining the principle evidence	We agree that the auditor should obtain the principle evidence, but we encourage the Board to more carefully define the concept of principle evidence.
17	Definitions of significant deficiency and material weakness	We have some concerns related to these definitions. First, we anticipate uneven application/interpretation of these definitions. Perhaps moving to a model using terms such as "low, medium, or high" risk of misstatement would result in more consistent application, given that these are commonly-used terms. Second, we are concerned that negotiations between auditors and clients will result in some weaknesses being "bargained down" to significant deficiencies so they will not be publicly disclosed. As a result, we wonder whether there would be merit to requiring public disclosure of <u>both</u> significant deficiencies and material weaknesses.
18	Examples in Appendix D	We found these examples to be helpful. However, we would like to see some discussion about the example of a material misstatement in the financial statements not being initially identified by the company's internal controls. Often, material misstatements identified by the external auditor are in the accounts which are estimates (e.g., allowance for doubtful accounts). Would misstatements identified by the auditor for these accounts be considered significant deficiencies (and possibly material weaknesses)? Or would it depend on whether the process management used to come up with the estimate was reasonable? Providing more discussion on this topic would be useful.

19	Necessity of evaluating all internal control deficiencies	We agree that all internal control deficiencies need to be evaluated. In addition, we recommend that the Board consider utilizing the risk management literature (as COSO has done for its Enterprise Risk Management Framework) to help in making these assessments. Auditors can assess the probability and magnitude of the risk of material misstatement given the control weakness as inputs into determining the severity of the control deficiency. Auditors can base their evaluation of the deficiency on measures such as the expected impact of the deficiency (computed as probability of misstatement times the impact). The assessments of severity ultimately should be based on professional judgment, but utilizing a framework to help in making that judgment helps to improve consistency.
20	Communicating all internal control deficiencies to management in writing	We agree that all internal control deficiencies need to be reported to management in writing.
21	Strong indicators of material weakness	We agree that these factors all reflect likely material weaknesses. However, we are concerned that the list of circumstances in paragraph 126 of the standard might lead to auditors not considering other circumstances. We recommend that the Board include language at the beginning of the paragraph very clearly stating that other circumstances may exist that should lead auditors to the same conclusion.
22	Appropriateness of auditor evaluation of audit committee oversight	We believe that it is appropriate for the auditor to evaluate the effectiveness of audit committee oversight – as part of both the internal control audit and the financial statement audit. Research clearly indicates that stronger audit committees are associated with reduced financial reporting risk. In addition, the literature (e.g., Beasley 1996 and others) also draws a strong linkage between overall board quality, particularly independence, and the risk of financial reporting problems. As a result, we encourage consideration of whether the auditor also should be specifically required to evaluate the overall board's oversight effectiveness when performing internal control or financial statement audits. Having said this, we do appreciate the practical and other concerns (see question 23 below) related to this requirement. In light of these concerns, one radical and perhaps cost-prohibitive suggestion is to require a second audit firm to perform the audit committee assessment on a less frequent basis (e.g., every 3 – 5 years).

23	Ability of auditors to effectively carry out responsibility to evaluate audit committee	We anticipate that this requirement could raise some significant issues in practice. The audit committee will both hire and be evaluated by the auditor. It certainly would be awkward in situations where the auditor concludes that the audit committee's oversight is ineffective, especially since this would be a specific criticism of the three or four members of the audit committee. In the past, investors were concerned that the auditor was hired by management and audited management's books. In a sense, that has been replaced by the auditor being hired by the audit committee and auditing the audit committee's oversight. In both instances, there is a conflict of interest for the auditor that must be recognized and managed. In today's environment, many investors may not believe that auditors can effectively carry out this responsibility from an appearance standpoint, if not from a fact standpoint. We call the Board's attention to press reports associated with the release of this proposed standard. Articles in major publications quickly noted that auditors would be evaluating those who hire and fire them. Going beyond the human/perception issues, we wonder whether there are liability concerns that may substantially limit the instances where an auditor cites ineffective audit committee oversight as a material weakness. For example, would an adverse internal control opinion citing inadequate audit committee oversight trigger shareholder suits against the directors? We encourage careful consideration of such issues.
24	Implications of audit committee representing material weakness	Given the concerns expressed in question 23 above, as a practical matter, we believe that the most likely outcome is that auditors simply will not accept/continue serving audit clients whose audit committees are ineffective. We would expect to see very few internal control opinions that cite inadequate audit committee oversight. Also, we question how requiring an auditor who has knowledge of a material weakness (sufficient to issue an adverse opinion) to withdraw from an engagement serves the public interest. Under the general standard of due professional care, we argue that an auditor with knowledge of ineffective audit committee oversight should issue an adverse opinion rather than be required to withdraw.
25	Material weakness requiring adverse opinion from auditor	We strongly agree that the presence of a material weakness must result in an adverse internal control opinion. In addition, we recommend that the Board discuss more explicitly in the standard the extent to which companies can fix controls that have been identified as significantly deficient in order to avoid an adverse opinion. For audits of financial statements, the threat of an adverse opinion

		traditionally has served as an important control to ensure that financial statements are corrected prior to being issued to the public. Based on our reading of the exposure draft, we are unclear on precisely to what extent this process is possible when auditing management's assessment of internal control.
26	Appropriateness of qualified "except for" auditor opinion	We do not believe that qualified "except for" opinions should be allowed in the presence of material weaknesses because the definition of material weakness states that there is "more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected." In such a case, we believe that internal control is, by definition, not effective – the company would not have "reasonable assurance regarding the reliability of financial reporting." In addition, we are not convinced that internal control can be compartmentalized very well. If there is a material weakness with one aspect of internal control, it is possible that the effects of this issue could permeate other areas. Again, overall internal control would not be effective. Given the above concerns, our view is that the presence of a material weakness should automatically result in an adverse internal control opinion. Finally, based on the spirit of the Sarbanes-Oxley Act in requiring adverse opinions for any material weakness, it might be most consistent to require disclaimers of opinion in any condition in which a material scope limitation exists. Under this line of reasoning, there would be no circumstances under which a qualified "except for" opinion should be allowed.
27	Auditor speaking directly to internal control effectiveness for non-standard opinions	We believe that requiring the auditor to speak directly to internal control effectiveness in such situations provides the most informative, least confusing reporting.

28	Providing specific guidance on independence and internal control-related non-audit services	If possible, it would be useful to add such guidance. For example, could the audit firm help in documenting the client's internal controls? Could the audit firm provide guidance on the internal control assessment process that management employs? We believe that many companies are hoping to be able to look to their external auditors for guidance on this whole process (including documentation requirements, number of items to test, etc.). If there are activities that the Board believes should not be performed, they should be specified in the standard. Without specific guidance, some firms, offices, or individuals may find themselves stepping over the line. Having said this, if this suggestion would result in significant delays in issuing the standard, then this issue could be addressed in subsequent standards.
29	Specific internal control-related non-audit services to prohibit	Please refer to question 28 above for some of the services that may be prohibited.
30	Auditor responsibilities for quarterly certifications – 4th quarter versus other quarters	Please refer to question 31 below regarding concerns over quarterly controls. In addition, we encourage the Board to work with the SEC to reconsider the decision to shorten the period for when the quarterly reports are due. Accounting firms were severely challenged when trying to meet the shorter deadlines for one review. It seems quite burdensome to potentially double the requirements on a quarterly basis without enabling a sufficient amount of time to effectively conduct both reviews.
31	Auditor responsibilities for quarterly certifications – appropriateness of scope	We have a significant concern related to internal controls over quarterly reporting, and we recognize that our concern actually ties back to the wording in the Sarbanes-Oxley Act and related SEC rules. Research (see Beasley, Carcello, and Hermanson, *Fraudulent Financial Reporting: 1987-1997, An Analysis of U.S. Public Companies*, COSO, 1999) indicates that financial statement fraud among U.S. public companies often begins in quarterly financial statements. A common pattern among the approximately 200 frauds studied was a fraud beginning in the first quarter of year 1, growing through the second, third, and fourth quarters of year 1, and then progressing through the first three quarters of year 2 (the typical fraud length was approximately two years, and a few frauds only involved interim periods). Our concern is that the 21-month fraud above would involve the misstatement of seven periods' financial statements (six quarters and one annual period), but only one of these seven periods (the annual

		period) is directly covered by the internal control reporting requirements (i.e., as of the end of the fiscal year). In other words, if management and the auditor have an obligation only to assess internal control effectiveness as of the end of the fiscal year, has the door been left somewhat open to allow fraud to occur during the first three quarters of the year? This may be the case if the controls over preparation of the quarterly financial statements are not as extensive or effective as the controls over annual financial statement preparation. While the definitions of "significant deficiency" and "material weakness" both refer to interim and annual misstatements, we are unclear how interim reporting risks can be evaluated effectively if controls over interim reporting are not extensively tested. In light of these concerns, we encourage more consideration of how to address internal control effectiveness in the first three quarters of the year. Again, we do recognize the constraints of the Act and the related SEC rules.

Other comments:

1. <u>Definition of internal control</u> – This comment also is offered recognizing that the Board is operating within the constraints of the Sarbanes-Oxley Act and related SEC rules on internal control reporting. The use of "internal control over financial reporting" seems to imply that there are different controls over operations and financial reporting. Under many of the information systems being utilized by publicly-traded companies, a common information system is utilized for operations and financial reporting. We suggest that the Board consider wording along the lines that the assurance is over any controls at the organization that can reasonably be expected to impact financial reporting. While this language change may appear subtle, we recommend avoiding any language that suggests there are multiple types of internal control. Rather, internal controls at an organization help to manage various risks at the organization, some of which have a direct impact on financial reporting. Other controls might only have an indirect impact on financial reporting (e.g., a lagged impact or an impact on another part of the organization that directly impacts financial reporting). While the standard provides the definition of internal control over financial reporting in paragraph 6, we are concerned that many controls related to key risks at the organization might not be investigated. The source of this concern is deciding when an internal control over financial reporting is *initiated*. For example, ineffective controls related to the customer service business process might impact the estimation process for warranties or recalls. However, under the proposed standard, it is not clear whether this control would fall under the proposed definition. This same problem is contained in the COSO (1992) framework that is used as background for this standard in paragraphs 13-14.

2. Heavy focus on control activities – The proposed standard seems to be focused more on the control activities component of COSO than on the other components. Our concern with this focus is that auditors are likely most familiar with the control activities component of COSO and would probably benefit from more direction, guidance, and examples related to the other four components of internal control (especially those that focus on entity-wide controls, rather than those that focus on initiating, recording, processing, and reporting transactions). For example, in the paragraphs discussing documentation (beginning with paragraph 43), there is not a lot of guidance as to what would be included in the documentation of the elements of the control environment (e.g., what should be documented about integrity of management, management's operating philosophy, etc.?). Similarly, in Appendix B, all of the examples related to extent of testing seem to focus on control activities. It would be helpful to have some examples for control environment controls, and others. The same applies to the examples provided in Appendix D.

3. Issues related to testing control effectiveness

    a. The discussion in paragraph 85 mentions that procedures used to test design effectiveness include inquiries, observations, and walkthroughs. Should review of documentation be added to this list of procedures?

    b. The tests discussed in the standard include inquiries of the client (see paragraph 90). Based on our understanding of the approaches being used by some client firms, some of the inquiry data are being obtained via structured surveys. We believe that the readers of the standard could benefit from some discussion about ensuring the validity of survey data, designing appropriate survey instruments/questions, etc.

    c. Paragraph 112 – Would it be useful to have some discussion as to the appropriateness of describing an identified exception as an "isolated instance?" We are concerned that some auditors may be too quick to consider an item isolated.

4. Other minor/editorial comments:

    a. Paragraph 22, 2nd bullet – We encourage additional explanation of this point. Our concern is that practitioners will not understand what types of qualitative factors to consider.

    b. Paragraph 24 – This paragraph relates to the control environment. However, one of the bullet points indicates "company's risk assessment process." Under COSO, the risk assessment process is not part of the control environment, but is a separate component of internal control. In addition, we wonder whether internal audit activity typically is identified as part of the control environment.

    c. Paragraph 50, 3rd bullet – It might be useful to elaborate on the last sentence. Could examples be provided?

    d. Paragraphs 85 and 87 – We encourage more specific guidance on testing design effectiveness. We are concerned that auditors will not have a good basis for performing such tests. Available guidance typically has discussions on assessing design effectiveness and then assessing and testing operational effectiveness. We are not familiar with much guidance on testing design effectiveness.

e. Paragraph 126 – This paragraph should specifically refer to paragraph 180. When reading paragraph 126 we had questions about the issues subsequently discussed in paragraph 180.

f. Paragraph 140 – We found the last sentence of paragraph 140 to be surprising. Research indicates that analytical procedures can be quite helpful in fraud detection, and SAS No. 99 specifically calls for auditors to perform analytical procedures to assist in fraud detection.

g. Paragraph 145 – The first bullet calls for the auditor to document "the evaluation of the design of each of the five components of the company's internal control over financial reporting." Does the Board truly intend for the auditor to document separate conclusions about each of the five components, given that only one overall opinion on internal control will be provided?

h. Paragraph 191 states that the auditor is not required to perform procedures sufficient to identify all internal control deficiencies. However, is the auditor required to perform procedures necessary to identify all significant deficiencies and/or all material weaknesses? A clarifying comment on this issue would be useful.

We hope that our suggestions are helpful and will assist in finalizing the auditing standard. Please feel free to contact our committee Chair for elaboration on or clarification of any comment.

Respectfully Submitted,

Auditing Standards Committee
Auditing Section, American Accounting Association

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The Auditing Standards Committee wishes to acknowledge the helpful insights of Heather Hermanson, Mark Peecher, and Ira Solomon.

November 21, 2003

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

Re: PCAOB Rulemaking Docket Matter No. 008- An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

Members and Staff of the Public Company Accounting Oversight Board:

I appreciate the opportunity to comment on the above-referenced docket matter.

I am both surprised and concerned about the language in the draft relating to reliance on the work of internal audit.

I am surprised because there has been an enormous amount of work put into developing a very thorough framework for the auditor's consideration of the internal audit function in an audit. The framework can be found in the AICPA professional standards/U.S. Auditing Standards (AU)/Section 322. This standard is based on Statement of Auditing Standard (SAS) 65. SAS 78 also further strengthens the framework by requiring a focus on corporate controls.

These current auditing standards already require a high degree of consideration before an external auditor can rely on the work of internal audit. The external auditor, among many other things, has to obtain an understanding of the internal audit function, assess their competence as well as their objectivity, consider the extent of the effect of the audit work, evaluate and test the quality and effectiveness of the internal auditors' work, assess the risk of a misstatement, and obtain evidence of management's assertions. The standard also specifically states that the external auditor has the ultimate responsibility to express an opinion and that responsibility can not be shared with the internal auditors.

I believe the auditing standards referenced (AU Section 322) should be incorporated into the language of the audit of internal control over financial reporting. Paragraph 104 in the current draft in particularl should be eliminated. This paragraph would prevent the external auditor from relying on the work of internal audit in a number of areas. Specifically, certain general controls such as physical environment, disaster recovery, business continuity, change management, network security, back-up procedures, database security, operating system security, and operations are possible areas where external audit might want to rely on the work of internal audit. Unfortunately, if the broadest interpretation of the limitation on information technology control testing is adopted, the external auditors will not be able to choose to rely on the work of internal audit. Consequently, the external auditors will perform much redundant work – in many cases with less competent staff – resulting in a lower quality of work at an unnecessarily high expense.

Many registrants have dedicated significant resources and achieved a high level of expertise in their internal audit departments**.** Particularly in the area of information technology, organizational expertise becomes more of a necessity as an organization's technology infrastructure gets larger and more complex. I believe most investors would prefer to place reliance on a seasoned group of information technology professionals with deep company-specific knowledge rather than a third party with less experience and more limited company-specific knowledge. Particularly if the work was performed in an objective manner and reperformed on a test-basis by the third party.

Another problem with paragraph 104 is that it is very ambiguous and appears to be contrary to the relevant auditing standards discussed above. Consequently, there appears to be a conflict regarding the reliance of internal audit for a financial statement audit versus the audit of internal control. Since these are for all intents and purposes performed in the same annual audit, I would recommend using the same audit standards.

I agree that under any number of scenarios a decision in which the auditor should not use the results of others, including external audit, might be the right decision. However, I believe current auditing standards already provide adequate guidance about how an external auditor should make that assessment.

Thank you for your consideration.

Charlie T. Wright, CIA, CISA
General Auditor, American Airlines

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December 10, 2003

Mr. Thomas Ray
Deputy Chief Auditor
Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006-2803

Re: Release No. 2003-17, 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

Dear Mr. Ray,

The American Bankers Association (ABA) is pleased to have this opportunity to comment on the proposed auditing standard issued by the Public Company Accounting Oversight Board (PCAOB), "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements" (the proposal). ABA brings together all categories of banking institutions to best represent the interests of the rapidly changing industry. Its membership – which includes community, regional, and money center banks and holding companies, as well as savings associations, trust companies and savings banks – makes ABA the largest banking trade association in the country.

The ABA commends the PCAOB on its efforts to establish standards for the audit of internal controls over financial reporting in conjunction with the audit of the financial statements as directed under the Sarbanes-Oxley Act of 2002. The banking industry is unique compared with other industries, as it has been required to follow rules to maintain strong internal control environments for many years under the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). Strong internal controls are critical, not only to provide users of financial statements with reasonable assurance about the integrity of financial statements, but also to provide management with a foundation for appropriately managing the company's risks.

We are concerned the proposal goes beyond the requirements set forth under the Sarbanes-Oxley Act and what is prudent at this time. The proposal requires an audit of internal controls over financial reporting rather than the attestation regarding management's assessment of internal controls that is required under the Sarbanes-Oxley Act. We agree with the definition of an attestation in the introduction to the proposal, which states that: "An attestation, in a general sense, is an expert's communication of a conclusion about the reliability of someone else's assertion."

This is what was intended in the Sarbanes-Oxley Act, and we believe that the PCAOB should require attestations rather than audits.

During the development of FDICIA, the accounting profession lobbied members of Congress to require that financial institutions provide certifications and accounting firms provide attestations on management assertions. Banking institutions are responsible for maintaining strong internal control environments. Banks document internal control responsibilities of employees, document the functions of internal controls and flow of processes, and test the reliance on internal controls. Since 1991, banks have been required to produce annual reports on internal controls, and external audit firms have assessed the effectiveness of bank internal controls and have attested to these reports. Many hours have been spent among bankers, banking regulators, and representatives from the accounting profession to specifically determine how such attestations were to be achieved. The Sarbanes-Oxley Act used the FDICIA attestation as its model.

The PCAOB's requirement to go beyond an attestation, to require a full audit, significantly alters the requirements under the Sarbanes-Oxley Act and will significantly increase the costs to companies. Audit firms are already quoting exorbitant fees to bankers under the assumption that the PCAOB will require audits rather than attestations. (In fact, audit firms are telling their banking clients that they must follow the PCAOB proposal for 2003 reporting – even though the rule is not final.) The accounting firms have not been able to sufficiently justify to bankers how their procedures will differ, how they are more valuable to shareholders, or specifically why the costs are so excessive.

We strongly suggest that the PCAOB require attestations rather than audits. Many industries, other than banking institutions, will have an enormous amount of work to do to document their internal control systems so that management will have a foundation on which to certify to its internal controls. Piling on the huge additional fees that are being quoted by the accounting firms for audits, as opposed to attestations, is simply unnecessary at this time. We believe that it would be much better for the PCAOB to require attestations, as contemplated during the development of and required by the Sarbanes-Oxely Act. We believe that the quality of attestations will likely improve dramatically even if the PCAOB does not require audits, simply because of the focus that has recently been placed on the accounting profession. Additionally, we respectfully encourage the PCAOB to reconsider the following areas in the proposal:

- External auditors should be permitted to rely on work performed by internal audit when appropriate.
- The walkthrough requirements are excessive and unnecessary.
- The requirement for external auditors to evaluate the effectiveness of audit committee should be removed from the proposal.
- The definitions of "significant deficiency" and "material weakness" are too broad and should be modified.
- "Except for opinions" should be permitted for circumstances involving business combinations or operating system changes.

External auditors can rely on work of others.
The proposal requires certain procedures to be followed by the external auditor to complete an audit of the internal controls over financial reporting. Because of the vast number of tests and extent of the audit, we believe that external auditors will need to be and should be permitted to exercise discretion on the extent to which the external auditor can rely on information provided by internal auditors.

We are concerned that the proposal creates unnecessary work for external auditors, and, frankly, unnecessary costs. Many functions performed by internal auditors within a company are recurring and routine in nature, and to require the external audit firm to prepare its own original documentation is duplicative. Further, if the quality of the internal audit function within a company is deemed to be reliable, there is no reason why the external auditor must duplicate such work. In fact, we would argue that if the external auditor relies on the work of a sound internal audit process, it frees up the auditing firm to focus on the important issue: areas of risk. We believe that the external audit firm, the company, and investors would benefit more by permitting the external audit firm to identify which tests should be performed and exercise professional judgment regarding the completion of the attestation. External auditors should not be prohibited from relying on the work of internal auditors, and should be permitted to use their work when it is prudent to do so.

Walkthroughs are excessive.
The proposal requires external audit firms to perform walkthroughs of all significant processes of a company each year as part of the audit firm's attestation on the effectiveness of internal controls. Banking institutions are required to maintain a reliable internal control environment. Instead of automatically requiring walkthroughs, external audit firms should use professional judgment to determine what additional evidence is needed each year regarding accounts, disclosures, or processes for the audit firm to gather sufficient, competent evidence to attest to management's assertion on internal controls.

External auditors should not assess audit committee.
The proposal requires that the external audit firm assess the effectiveness and independence of the audit committee. This should be eliminated from the proposal. External audit firms are not necessarily equipped to make such an assessment, they are not trained in making these types of evaluations, and there are no rules or guidelines against which firms would make such assessments. Further, this requirement creates a conflict of interest between auditors and audit committees with respect to independence. Under rules issued by the SEC and stock exchanges, the external audit firm reports to the audit committee. The audit committee also has the sole authority to hire and remove the external audit firm and establishes the compensation for the external audit firm. Independence of the accounting firm is also disclosed to shareholders by the Board of Directors for shareholders to evaluate. We believe that the proposal, as drafted, is not workable and should be removed from the proposal.

<u>Definitions of "significant deficiency" and "material weakness" are too prescriptive.</u>
The terms "significant deficiency" and "material weakness" in the proposal are too narrowly defined and could cause unwarranted concern over a company's internal control structure. Defining a material weakness as having a "more than remote likelihood of occurrence" is broad and too low a threshold to assist in evaluating internal control deficiencies.

The American Institute of Certified Public Accountants (AICPA) identified thresholds for evaluating reportable conditions regarding material weaknesses in its Professional Standard AU Section 325 and Standard AT Section 501. Rules issued by the Securities and Exchange Commission pursuant to Section 404 of the Sarbanes-Oxley Act reference the AICPA's Section 325 and Section 501 as the standards that should be used in determining whether a significant deficiency or material weakness exists within a company. We believe that those particular AICPA Standards contain a more clear definition of a reportable material weakness than the definition provided in the PCAOB proposal. We encourage the PCAOB to modify the definitions of "significant deficiency" and "material weakness" to be based on the reasonably likelihood that an internal control would cause a significant or material misstatement of the annual or interim financial statements. In this way, disclosures would be based on a reasonable level and would provide investors with more important and useful information about failures in internal controls. It is important that the definitions be based on reasonable thresholds that would provide reasonable assurance that a failure in internal controls exists.

<u>"Except for opinions" should be permitted.</u>
External audit firms should be permitted to issue "except for" opinions in situations that involve mergers, acquisitions, or systems changes that affect the internal control environment of the bank. During the time when companies engage in mergers or acquisitions, it often takes time for the acquiring company to learn the internal functions of the acquired company, integrate operating systems, and convert internal control processes to the acquiring company. Often, legacy systems are maintained for a brief period of time until systems can be transitioned to the surviving company. There can also be situations near the end of the reporting cycle that would make it difficult for the acquiring company to consolidate, evaluate, and certify the internal control environment of the combined company. In these situations, it may not be possible for the audit firm to conduct a comprehensive evaluation of the combined company's internal controls, and external audit firms should be given permission to issue "except for" opinions on the attestation on the combined company's internal control environment.

In conclusion, we believe that the PCAOB should require attestations rather than audits. We believe that external auditors should be permitted to rely on work performed by internal audit when appropriate and that external auditors should evaluate processes in order to determine whether walkthroughs on all processes are needed. The requirement for external auditors to evaluate the effectiveness of audit committees should be removed from the proposal. The definitions of "significant deficiency" and "material weakness" are too narrow and should be modified to provide users of financial statements with useful and meaningful information. Last, we believe that "except for opinions" should be permitted for circumstances involving business combinations or operating system changes.

Thank you for the opportunity to comment on this proposal and for your consideration. If you would like to discuss this letter in more detail, please contact me at 202-663-5318.

Sincerely,

Donna Fisher

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February 5, 2004

Mr. Thomas Ray
Deputy Chief Auditor
Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 008: An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

Dear Mr. Ray,

The American Bankers Association (ABA) is pleased to have this opportunity to comment on the proposed auditing standard issued by the Public Company Accounting Oversight Board (PCAOB), "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements" (the proposal). ABA brings together all categories of banking institutions to best represent the interests of the rapidly changing industry. Its membership – which includes community, regional, and money center banks and holding companies, as well as savings associations, trust companies and savings banks – makes ABA the largest banking trade association in the country.

We wish to supplement to our letter of December 10, 2003 with this letter. Although we recognize that the comment period has ended, we have learned some additional important information that we hope the PCAOB will consider prior to issuing final rules.

As you know, banks have been required to prepare management reports on internal controls and auditors have been required to attest to management's assertions for many years under the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). Some banks have purchased computer software that is in a question and answer (Q&A) format to identify and evaluate controls. Our concern is that the proposal is being read by accounting firms as no longer permitting the Q&A format. To provide a specific example, a banking institution ($2.5 billion in total assets) that uses a Q&A format has been told by its accounting firm that the bank must convert from the Q&A to either a flowchart or narrative. The bids that the bank is receiving for such conversion are between $200,000 and $300,000. Our hope is that this is not the intent of the PCAOB and that you will clarify this in your final rules.

The proposal requires that auditors perform certain procedures in order to evaluate management's assessment process. It requires auditors to determine whether management's documentation provides reasonable support for its assessment, including an evaluation of whether certain information is included in the entity's documentation (a list is provided at paragraph 43 of the proposal).

The proposal also states that documentation might take many forms, and that no one form of documentation is required:

> Paragraph 44: "Documentation might take many forms of presentation and can include a variety of information, including policy manuals, process models, flowcharts, job descriptions, documents and forms. No one form of documentation is required, and the extent of documentation will vary depending on the size, nature, and complexity of the company."

We are curious as to whether the PCAOB believes that Q&A formats must be replaced by narratives or flowcharts. If controls can appropriately be identified and evaluated with a Q&A format, should the Q&A be acceptable? If the PCAOB intends to use narratives and flowcharts rather than the Q&A, is there sufficient additional benefit to justify the cost of converting from the Q&A to narratives or flowcharts? Although the proposal does not currently appear to intentionally preclude the use of the Q&A, is it possible that list in paragraph 43 and the walkthroughs in paragraph 79 effectively eliminate the use of the Q&A format?

The SEC final rules relating to Section 404 of the Sarbanes-Oxley Act of 2002 are not significantly different from the FDICIA requirements. However, the PCAOB rules seem to establish new rules not only for accounting firms, but also for the companies they audit by requiring documentation that reaches well beyond the existing requirements. We are not suggesting that additional documentation may not be needed; instead, our hope is that if the PCAOB's final rules result in new rules for banking institutions, the PCAOB will carefully consider the impact of such rules, including costs versus benefits.

Again, we would appreciate your consideration of these points prior to issuing a final rule if at all possible. If you would like to discuss this letter in more detail, please contact me at 202-663-5318.

Sincerely,

Donna Fisher

AMERICAN BAR ASSOCIATION
Section of Business Law
750 North Lake Shore Drive
Chicago, IL 60611

December 2, 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

Dear Board Members:

On behalf of the Committee on Law and Accounting and the Committee on Federal Regulation of Securities, Section of Business Law of the American Bar Association (jointly, the "Committees"), we are pleased to have the opportunity to comment on the Public Company Accounting Oversight Board's (the "PCAOB") proposed auditing standards relating to audits of internal control over financial reporting (the "Proposed Standards").

The comments expressed in this letter represent the views of the Committees only and have not been approved by the American Bar Association's House of Delegates or Board of Governors and therefore do not represent the official position of the ABA. In addition, they do not represent the official position of the ABA Section of Business Law, nor do they necessarily reflect the views of all members of the Committees.

The Committees recognize the PCAOB's obligation to implement the legislative mandate of Sections 103(a)(2)(iii) and 404(b) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") and support the PCAOB's overall approach in the Proposed Standards. While the Committees believe that the Proposed Standards should achieve the goal of ensuring the confidence of the investing public in the integrity of public companies' internal control over financial reporting, highlighted below are certain aspects of the PCAOB's proposals with which the Committees do not agree and our suggestions that are intended to clarify the Proposed Standards.

I. Audit Committee Proposals.

The Committees acknowledge the central role of the audit committee in the oversight of a company's financial reporting process. However, we believe that the proposed attestation standards relating to the audit committee are not consistent with the requirement that the audit committee appoint and oversee the outside auditors.

Under Section 301 of Sarbanes-Oxley and the rules and regulations promulgated thereunder by the Securities and Exchange Commission (the "SEC"), the New York Stock Exchange and The Nasdaq Stock Market (the "SROs"), a listed company's audit committee is directly responsible for the appointment, compensation and oversight of the work of the company's outside auditors. Because of the direct supervision obligations that have been imposed on such audit committees by Congress, the Proposed Standards appear flawed and circular in their requirement that the very body that is directly responsible for appointing and determining compensation of the outside auditors, as well as directly overseeing their work, would be subject, in turn, to that outside auditors' scrutiny as part of its audit of internal control over financial reporting.

In addition, we believe that a weakness in the oversight by the audit committee of the financial reporting process may suggest a deficiency in the way the outside auditors manage their relationship with the audit committee. Such a deficiency should be addressed by the outside auditors through better communication with the audit committee. If such dialogue does not improve the effectiveness of the audit committee, the outside auditors should consider resigning.

We disagree with the identification in Paragraph 53 of the activities of the audit committee as an example of the activities that the outside auditors should evaluate as a part of the "monitoring of controls." The audit committee's oversight role is not comparable to the monitoring role of the internal audit function, the CEO and CFO certification process or any other process that a company follows to ensure the adequacy of its financial disclosures, including as a result of the certifications required by Sections 302 and 906 of Sarbanes-Oxley. In our opinion, it is more appropriate for any evaluation of the audit committee's oversight role to be considered in connection with a general review of a company's control environment.

In our view, not only are the proposed attestation procedures relating to the audit committee not contemplated by Sarbanes-Oxley, they may be duplicative of the responsibilities imposed and enforced by the SEC, the SROs, state law and stockholders on boards of directors and audit committees. Moreover, some of these proposed procedures would require that the outside auditors make legal judgments and therefore not judgments within their expertise. We specifically recommend deleting, or revising, if not deleting, the following proposed procedures:

- Paragraph 57 of the Proposed Standards would require the outside auditors to evaluate the independence of the audit committee as one of the factors related to the effectiveness of the audit committee's oversight of external financial reporting and internal control over financial reporting. In evaluating the audit committee's independence, Paragraph 58 of the Proposed Standards would require the outside auditors to evaluate how audit committee members are nominated and selected and whether they act independently from management. We do not agree with, and are troubled by, the conclusion in Paragraph 58 that audit committee members are more likely to be independent if they are nominated through an independent process. More importantly, the evaluation of independence is more properly a corporate governance matter, which is governed by the mandates of Section 301 of Sarbanes-Oxley, state law, SEC regulations and listing standards (as acknowledged by the PCAOB in Footnote 13 to the Proposed Standards), than a matter for the outside auditors in the context of their evaluation of internal control. Boards of directors are required by applicable listing standards to make an affirmative determination of independence for each outside director. Furthermore, a recently-adopted SEC rule that addresses, in part, disclosure relating to nominating committee functions, will result in significant public disclosure of the details surrounding a company's nomination process. See SEC Release No. 33-8340 (November 24, 2003). Therefore, the Committees find it an unnecessarily duplicative and costly requirement, and one with respect to which the outside auditors lack expertise, for the outside auditors to evaluate matters of director independence. Moreover, because the audit committee is established by the board of directors, which has the ability and responsibility to replace committee members and alter the audit committee charter as necessary or appropriate, the board of directors is the proper body to evaluate the audit committee's performance.

- Paragraph 57 would require the outside auditors to evaluate the clarity with which the audit committee's responsibilities are articulated and how well the audit committee and management understand those responsibilities. We assume that this factor would require a review of the audit committee charter, which is a publicly-filed document available to stockholders. We believe that the review of the charter by the outside auditors and evaluation of whether the audit committee and management understand those responsibilities are matters more appropriately covered by the board self-assessment process and are not matters within the expertise of the outside auditors.

- Paragraph 57 would require the outside auditors to evaluate the level of involvement and interaction of the audit committee with the outside auditors, including the audit committee's role in their appointment, retention and compensation. This circular requirement could create conflicts of interest for the audit committee. As noted above, audit committees of listed committees will be required by law to perform these duties.

- Paragraph 57 would require the outside auditors to evaluate the level of involvement and interaction of the audit committee with the internal audit department, including the audit committee's line of authority and role in appointing and compensating employees in the internal audit function. In addition, Paragraph 24 identifies the internal audit activity as a control intended to address the risks of fraud. These Paragraphs assume, incorrectly, that all companies have an internal audit function. While NYSE-listed companies are required by the new corporate governance listing standards to have an internal auditor function, NYSE-listed companies are permitted to outsource the internal auditor function and Nasdaq-listed companies and other companies are not so required. Therefore, this requirement, if retained, should be revised to acknowledge that some companies may not have employees performing internal audit functions or may not have, and may not need to have, an internal audit function at all.

- Paragraph 57 would require the outside auditors to evaluate the audit committee's compliance with applicable listing standards adopted pursuant to Section 301 of Sarbanes-Oxley. As noted above, this is a circular requirement and one that would be inconsistent with Rule 10A-3 promulgated under the Securities Exchange Act of 1934, as amended, under which audit committees must comply with applicable listing standards or face delisting.

- Paragraph 57 would require the outside auditors to evaluate whether the audit committee has an audit committee financial expert. Besides the fact that this information is required to be disclosed in a company's public filings, we question whether the existence of an audit committee financial expert is probative of whether an audit committee is functioning appropriately.

- Paragraph 57 would require the outside auditors to evaluate the amount of time the audit committee devotes to control issues and other committee activities. An evaluation of the time spent would be incomplete absent discussions with the members of the audit committee to determine the time that each member spends preparing for audit committee meetings. Interviewing audit committee members to determine this accurately does not seem like a good use of auditor time. In addition, the time spent by the audit committee is of far less importance to the evaluation of the oversight role played by the audit committee than the way in which that time was used. Intense analytical discussions about accounting or internal control issues during a four-hour period among fully prepared audit committee members will result in far more effective oversight than unfocused discussions between audit committee members who are not prepared to discuss the issues. We believe this proposal should be deleted. If it is retained, we request that the PCAOB consider revising the language to focus on the audit committee's quality of participation in committee activities rather than the amount of time the members devote to those activities.

- Paragraph 72 would require the outside auditors to evaluate the nature and extent of the audit committee's involvement in the period-end financial reporting process. This evaluation would appear to require, with respect to NYSE-listed companies, an evaluation of compliance with listing standards, a legal judgment. Furthermore, because the audit committee's period-end evaluation process significantly depends upon input from and interaction with the outside auditors, we are not certain what is contemplated by the inclusion of this factor as an auditing standard.

Finally, we believe that the Proposed Standards inappropriately broaden or characterize the scope of audit committee duties. In some cases, the Proposed Standards go beyond what the law requires. For example, Paragraph 24 of the Proposed Standards suggests that the audit committee is responsible for monitoring the code of conduct. Although the audit committee often has this responsibility, it is not required under applicable listing standards and regulations or any state or federal law. In addition, the reference in Paragraphs 34 and 35 of the Proposed Standards to the audit committee's responsibilities with respect to the outside auditors' independence could be understood to suggest a shift to the audit committee of some of the outside auditors' independent burden to determine its own independence.

II. <u>Issues Related to the Scope of the Audit</u>.

The Committees agree that the process of auditing internal control over financial reporting should be done in connection with audit of the financial statements and will require more than just merely acknowledging that auditor agrees with management's assessment. Audit fees appear to have increased significantly since 2002, and costs associated with an audit of internal controls will surely result in substantial additional increases in audit fees. We urge the PCAOB to consider ways to reduce the scope of the procedures required by the Proposed Standards, and thereby reduce the attendant costs to reporting companies, to more closely tailor the procedures to those required by Sarbanes-Oxley without adversely affecting the quality of the internal control audit.

Mindful of mounting compliance costs, the Committees submit that certain of the approaches contemplated by the Proposed Standards appear to be duplicative of other procedures and, therefore, unnecessary. In addition, the Proposed Standards require a great deal of origination of supporting evidence by the outside auditors. For those procedures that are necessary in the audit process, we generally support, where appropriate, greater permissibility of the outside auditors' use of professional judgment in determining the extent to which reliance on the work performed by the internal auditors is appropriate.

The PCAOB states on page eight of the Summary of the Proposed Standards that: "the more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be." We agree with the appropriateness of this approach but, as drafted, the outside auditors do not appear to be permitted to rely very much on management's work at all. Therefore, we question the conclusion that the Proposed Standards will permit the outside auditor's work to be less extensive if management's assessment is relatively more complete. Given that management's assessment is at a level of "reasonable assurance," which "includes the understanding that there is a relatively low risk that material misstatements will not be prevented or detected on a timely basis" (as contemplated by Paragraph 16 of the Proposed Standards), we also recommend that the Proposed Standards permit a reasonableness evaluation by the outside auditors in determining what procedures are required in the audit.

As noted above, the Proposed Standards require that a great deal of the supporting evidence for the outside auditors' opinion originate with the outside auditor. However, Paragraph 109 of the Proposed Standards is unclear as to whether all "principal evidence" must originate with the outside auditors.

We also question whether the procedures called for by the Proposed Standards ought to be required to be performed on an annual basis and whether the same level of testing each year is really necessary to justify the additional expense of such testing. It may be more appropriate to permit the outside auditors to use the previous year's audit evidence in some cases. However, with increased reliance on internal auditors, as discussed below, annual testing may be more acceptable.

Where appropriate, the PCAOB should consider permitting more reliance on the internal auditors' work once the outside auditors confirm their understanding of internal control over financial reporting and test the internal auditors' tests. We note that Statements on Auditing Standards Number 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, provides well-established guidance to outside auditors in determining the nature, timing and extent of auditing procedures to be performed in an audit of an entity's financial statements. We would suggest that the PCAOB consider allowing outside auditors to use the same or similar criteria in assessing the appropriateness of reliance on the work of the internal auditors in connection with an internal control audit, even with respect to matters covered in Paragraphs 104 and 105 of the Proposed Standards. To do otherwise could result in unnecessary re-testing of controls. If an internal auditor follows applicable professional standards, reports to the audit committee, is deemed independent of management and is considered by the outside auditors to do reliable work, reliance ought to be permitted consistent with current practice.

One of the procedures called for by the Proposed Standards with respect to which the outside auditors would be precluded from relying on others is the proposed requirement that the outside auditors perform "walkthroughs" in the audit process. To the extent that it is reasonable for the outside auditors to rely upon the work of the internal auditors, the outside auditors should be permitted to rely, to a significant extent, on walkthroughs that have already been completed. That said, if a walkthrough is required as part of the final standards, the PCAOB should consider whether it is necessary and cost-effective to extend that procedure to <u>all</u> of the company's significant processes and include <u>all</u> types of company transactions and events, both routine and unusual, as is currently required by Paragraph 79 of the Proposed Standards.

In our opinion, additional reliance could also be placed on management's work or the work of third parties where the outside auditors appropriately test the work to evaluate the extent to which the outside auditors could reasonably rely upon it. We encourage the PCAOB to consider whether that approach could be permitted in the following specific areas:

- The identification of significant accounts as contemplated by Paragraph 60.
- The identification of relevant financial statement assertions as contemplated by Paragraph 66.
- The identification of significant processes as contemplated by Paragraph 69.
- The identification of controls to test as contemplated by Paragraph 74.
- The evaluation of the use of work performed by management and others as contemplated by Paragraph 103.

We also question the proposal to broaden the responsibilities of the outside auditors to include disclosures outside the financial statements. Paragraph 184 would require the outside auditors to "evaluate" with management appropriate disclosure about a change in internal control over financial reporting resulting from the need to correct a material weakness. It may be more appropriate to require a "review" rather than an "evaluation," as the latter would appear to come very close to requiring the outside auditors to act in a managerial capacity.

We recommend that the Proposed Standards address the attestation and reporting requirements when a company's internal control over financial reporting has not been fully reviewed and appropriately modified after a merger, acquisition or corporate restructuring that took place too close to the end of the fiscal year for such a review to have been completed. For example, the requirement in Paragraph 128 for management representations should acknowledge and provide guidance as to how to respond when management may be unable to make the necessary representations as to the internal controls. In addition, in such circumstances, a qualified opinion or "except for" opinion should be acceptable rather than an adverse opinion, which is what the Proposed Standards would require.

A qualified opinion can be useful to convey information to stockholders that would otherwise not be conveyed by a blanket adverse opinion. In addition to a qualified opinion providing more meaningful information about the impact of a recent acquisition or restructuring on a company than an adverse opinion, a qualified opinion may be preferable to an adverse opinion in other contexts. For example, it could highlight that a deficiency is confined to one business segment.

Finally, we question the requirement in Paragraph 145 of the Proposed Standards that the outside auditors' documentation of their attestation work include an evaluation of all deficiencies. We encourage the PCAOB to consider whether the documentation needs to include an evaluation of deficiencies other than "significant deficiencies."

III. Clarification of Definitions.

We are concerned about the clarity and potential consequences of the proposed definitions of "significant deficiency" and "material weakness." Not only has the PCAOB not used the definitions in existing generally accepted auditing standards ("GAAS") (AU Sections 325 and 501) of "reportable condition" and "material weakness," but the PCAOB has also not explained how the proposed definitions would differ from the existing terms under GAAS. Moreover, the PCAOB's use of the term "more than a remote likelihood" in the proposed definitions would appear to be a lower standard than existing GAAS and would require many more deficiencies in internal control to be identified as "significant" or as "material weaknesses" than under current GAAS.

In view of the severe consequences to a company if its internal control over financial reporting is considered to have significant deficiencies or material weaknesses, we recommend that the definitions be clarified to be consistent with existing GAAS. In addition, we recommend that the PCAOB provide further examples of significant deficiencies and material weaknesses to enhance the likelihood of more consistent conclusions by outside auditors as to the types of deficiencies in internal control that should be considered to be significant deficiencies or material weaknesses. Such guidance would be particularly important with respect to the independence and effectiveness of the audit committee if the PCAOB retains the attestation procedures related to the independence and effectiveness of the audit committee.

Thank you for your consideration of our comments on this important matter. Please do not hesitate to contact the undersigned with any questions you may have.

Cordially,

/s/ Thomas L. Riesenberg

Thomas L. Riesenberg,
Chair of the Committee on Law and Accounting of the American Bar Association, Section of Business Law

/s/ Dixie L. Johnson

Dixie L. Johnson,
Chair of the Committee on Federal Regulation of Securities of the American Bar Association, Section of Business Law

cc: Drafting Committee:
Linda L. Griggs, Chair
Susan Blount
John T. Bostelman
Richard E. Gutman
Stanley Keller
Sam Scott Miller
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American Federation of Labor and Congress of Industrial Organizations

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November 21, 2003

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

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

Dear Sir/Madam:

On behalf of the American Federation of Labor and Congress of Industrial Organizations, I am writing to express our strong support for the Public Company Accounting Oversight Board's proposed standard for the audit of internal financial controls. The PCAOB's proposed auditing standard will be a significant contribution to restoring investor confidence in the financial statements of American corporations.

The AFL-CIO is the federation of America's labor unions, representing more than 66 national and international unions and their membership of more than 13 million working women and men. Union members participate in benefit plans with over $5 trillion in assets. Union-sponsored pension plans hold almost $400 billion in assets, and union members also participate in the capital markets as individual investors.

We applaud the thoughtful and comprehensive approach the PCAOB has taken in its proposed rulemaking. This new standard, mandated by the Sarbanes-Oxley Act, empowers audit firms to examine and test systems put in place by companies to ensure the soundness of their financial statements. This marks an important step in preventing the kind of accounting scandals that have shaken investor faith in corporate America.

The proposed standard strikes the right balance between the obligations placed on public companies and their auditors, and the needs of investors to have assurances that corporate internal controls are effective. As investors, we believe that any additional costs that companies incur in meeting the proposed standard will be greatly outweighed by the savings shareholders will gain from more accurate financial statements.

A key provision of the new standard is the requirement that auditors evaluate and test – not simply report on – the internal controls at large companies. The risk of a breakdown of a firm's own internal controls such as occurred at Worldcom grows with the company's size and complexity. Requiring accountants to test their client's internal controls will empower auditors to meet with employees involved at various stages of the financial reporting process, and thereby reinforce proper accounting procedures.

Last but not least, we wholeheartedly support the requirement that external auditors evaluate the effectiveness and independence of the audit committee. As the collapse of Enron showed, an ineffectual and conflicted audit committee is a recipe for disaster. The simple fact of having to attest that the audit committee is doing its job will encourage auditors to politely remind them to do it. Such a standard might have prevented the resulting loss of confidence in Arthur Anderson.

We congratulate Chairman McDonough and the other members of the Public Company Accounting Oversight Board for a job well done, and thank them for this opportunity to express our views.

Sincerely,

Richard L. Trumka

RLT/meb
opeiu#2,afl-cio

AICPA

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

Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*

Dear Mr. Secretary:

The American Institute of Certified Public Accountants ("AICPA") respectfully submits the following written comments on the Public Company Accounting Oversight Board's ("PCAOB" or "Board") proposed auditing standard (the proposed standard) governing the independent auditor's attestation and reporting on management's assessment of the effectiveness of internal control over financial reporting pursuant to Section 103(a)(2)(A) of the Sarbanes-Oxley Act of 2002 ("the Act"). Our comments reflect our views as they pertain to audits of issuers subject to the Act and do not necessarily reflect our viewpoint for audits of nonissuers. The AICPA is the largest professional association of Certified Public Accountants in the United States, with more than 330,000 members in public practice, business, industry, government, and education.

Executive Summary

The AICPA has long supported reporting on the effectiveness of internal control over financial reporting by public companies accompanied by auditor attestation because effective internal control is a critical component of reliable financial reporting. We believe that this practice will lead to increased quality in the preparation of financial statements.

The AICPA recognizes the enormous effort put forth by the PCAOB members and staff to implement the provisions of the Act. Initially, a significant responsibility of the PCAOB will be to help restore public confidence in audited financial statements of public companies. The establishment and maintenance of high quality auditing and other professional standards is critical to that goal. The AICPA is committed to working cooperatively with the PCAOB in the continuous improvement of high quality audit standards.

We believe that incorporating our recommendations into the final standard will enhance auditors' reports for users and also will significantly improve implementation of the requirements of the Act both by auditors and issuers. The following are among our more significant recommendations:

- **Retain the auditor's option to express either a qualified opinion or an adverse opinion when there is a material weakness in internal control over financial reporting.** Reporting options provide better, more flexible disclosure and thus are more informative for users of the report. We believe reporting alternatives also are consistent with the Securities and Exchange Commission's ("SEC") reporting guidance for management.

- **Identify and communicate to the profession and to the public *all* areas where proposed requirements diverge from existing requirements in the Board's interim standards.** Some significant changes have been made that relate to audit areas other than internal control over financial reporting. These modifications are not discussed in the introductory material to the proposed standard and easily could be overlooked by auditors.

- **Require the auditor to assess the effectiveness of the audit committee within the consideration of the overall control environment instead of as a separate evaluation.** The audit committee is only one element of the control environment and its effectiveness should be assessed as part of the overall control environment. In addition, the criteria to assess this element of the control environment should be clarified and strengthened.

- **Change the requirement that the auditor, in performing walkthroughs, should trace *all* types of transactions and events, both recurring and unusual, from origination to reflection in the financial reports.** This requirement excludes any consideration of materiality, removes auditor judgment, and will be costly to implement with little incremental benefit. We believe that the auditor should perform independent walkthroughs for all the company's significant processes and for *significant* events and transactions.

- **Work in conjunction with the SEC to develop more definitive guidance about management's extent of testing.** Issuers appear to hold widely differing views about the extent of tests of controls that is appropriate to provide sufficient evidence to support management's assessment. We urge the PCAOB to coordinate with the SEC on the issuance of guidance on management's extent of testing.

Specific Recommendations

Forming an Opinion and Reporting

We strongly believe that the auditor should be permitted to express either a qualified opinion or an adverse opinion when there is a material weakness in internal control because these different reporting options are more informative for users of the auditor's report. We also believe that permitting these reporting options is consistent with the SEC's reporting guidance for management.

The SEC's release on the final rules implementing section 404 "preclude management from determining that a company's internal control over financial reporting is effective if it identifies one or more material weaknesses in the company's internal control over financial reporting." Footnote 72 at this sentence states that "this is consistent with interim attestation standards. See AT § 501."We agree with the above conclusion and with paragraph 37 of AT section 501 in the Board's interim standards which states:

> . . . the presence of a material weakness will preclude the practitioner from concluding that the entity has effective internal control. However, depending on the significance of the material weakness and its effect on the achievement of the objectives of the control criteria, the practitioner may qualify his or her opinion (that is, express an opinion that internal control is effective "except for" the material weakness noted) or may express an adverse opinion.

Accordingly, we believe that the SEC's final rule does not preclude management's expression of a qualified "except for" conclusion about the effectiveness of its internal control over financial reporting, depending on the significance of the material weakness, consistent with the above guidance.

Alternative reporting options that are based on the significance of the material weakness and its effect on the achievement of the objectives of the control criteria provide better, more flexible disclosure that is more informative for users of the report. In some circumstances, the auditor may conclude that the effect of one or more material weaknesses on the achievement of the objectives of the control criteria is pervasive enough that it renders internal control, taken as a whole, ineffective. An example of such a material weakness might be the existence of multiple material weaknesses in several different applications. In such circumstances, an adverse opinion that "internal control over financial reporting is not effective in all material respects" is appropriate and communicates to users of the report the gravity of the effect of the material weakness on achieving the entity's overall internal control objectives.

In other circumstances, the auditor may conclude that the effect of the material weakness on the achievement of the objectives of the control criteria is more isolated and does not result in ineffective internal control taken as a whole. An example of such a material weakness might be inadequate controls at a subsidiary that the company acquired in the last week of the year. In such circumstances, the auditor may determine that an adverse opinion is not appropriate, and perhaps potentially misleading, because the significance of the material weakness is not pervasive enough to warrant a conclusion that internal control, taken as a whole, is ineffective. In such circumstances, the auditor may determine that a qualified, "except for," opinion, such as the following from paragraph 55 of AT section 501 in the Board's interim standards, is more appropriate, and also more informative for users of the report, than a conclusion that "internal control is not effective":

> In our opinion, except for the effect of the material weakness described in the preceding paragraph on the achievement of the objectives of the control criteria, W Company has maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X3, based on [*identify criteria*].

In addition, we believe that the requirement always to express an adverse opinion when there is a material weakness places smaller companies at a disadvantage since smaller companies may be more predisposed to have specific material weaknesses that are not pervasive. In such circumstances we believe that a qualified "except for" report is more informative for investors.

We agree that when the auditor issues a non-standard opinion, such as a qualified or adverse opinion, the auditor's opinion should speak directly to the effectiveness of the internal control rather than to whether management's assertion about the effectiveness of internal control is fairly stated.

Process for Identifying and Communicating Changes to Various Interim Standards

We note areas where guidance in the Board's interim standards has been modified in subtle but significant ways, particularly with regard to substantive procedures. For example, paragraph 138 states that "the auditor should perform substantive procedures *for all relevant assertions* [italics added] for all significant accounts and disclosures." As additional examples, paragraph 141 states that "the auditor's substantive procedures must include reconciling the financial statements to the accounting records;" and paragraph 140 states that "for significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient."

Our comment does not relate to the substance of the proposed changes, but to the process by which these proposed changes have been identified and communicated. We believe that proposed standards should identify and communicate to the profession and to the public how requirements diverge from existing requirements and how issuance of the standard would affect existing standards. The introductory discussion of the proposed standard appropriately focuses on reporting on internal control. However, it fails to mention other changes in auditing requirements, some of which auditors would consider to be significant. Furthermore, since some of these changes are only a sentence or two in a document that is over 100 pages in length, they easily could be overlooked.

Accordingly, we strongly urge the PCAOB to highlight in the final standard all such changes to existing requirements and describe how the issuance of this proposed standard affects the Board's existing interim standards.

Evaluating the Effectiveness of the Audit Committee's Oversight

We agree that the audit committee, which along with the board of directors comprises one of the factors of the control environment in the Committee of Sponsoring Organizations of the Treadway Commission's report, *Internal Control—Integrated Framework* (the COSO report), plays a significant role in the oversight of a company's internal control over financial reporting and in creating a positive "tone at the top." Accordingly, we believe that the auditor's responsibility to evaluate the control environment encompasses consideration of factors about the board of directors and the audit committee such as those outlined on pages 26 and 27 of the COSO report. Even though the auditor evaluates the control environment in its totality and does not separately conclude on any single element of the control environment, we do agree that the importance of those who govern is such that their overall ineffectiveness generally would lead to a conclusion that the control environment is ineffective. Therefore, we recommend that the proposed standard be revised to require the auditor to assess the audit committee's effectiveness as part of evaluating the company's overall control environment which includes those who govern. We also believe that it is the responsibility of the board of directors to evaluate the effectiveness of the overall board including the audit committee.

In order to achieve more consistent and effective assessment of the audit committee as part of the auditor's evaluation of the overall control environment, we also believe that the PCAOB should clarify and strengthen the guidance in paragraph 57. For example, some of the factors that the auditor would be required to assess in paragraph 57 of the proposed standard could be subject to inconsistent interpretation. Since the auditor does not have unfettered access to the audit committee, the auditor's ability to assess the committee's commitment of time to its activities or to internal control and to evaluate the involvement and interaction with external and internal auditors would be difficult and additionally may not be a meaningful measure of the audit committee's effectiveness. It presumes that levels of time and interaction are measurable when in reality each situation will call for different efforts and degrees of involvement. Therefore, to assess effectiveness against levels of time, effort, and interaction is neither appropriate nor effective.

In addition, in the first bullet of paragraph 57 or in paragraph 58, "independence" should be specifically defined so that everyone is using the same criteria to assess it. The second bullet of paragraph 57 should be clarified to identify potential written sources (for example, the charter) that would be expected to enumerate the audit committee's responsibilities. Finally, we believe that the audit committee's "compliance with applicable listing standards adopted pursuant to Section 301 of the Act" and "whether the committee includes one or more financial experts as described in Section 407 of the Act" (the fifth and sixth bullets) are matters for legal determination and outside the scope of the auditor's responsibility.

As discussed above, the auditor does not have unlimited access to the audit committee. Therefore, if the PCAOB retains the requirement that the auditor make a separate evaluation of the audit committee, we recommend that the PCAOB require the auditor to obtain a written representation from the audit committee in order to facilitate the auditor's obtaining the additional evidence necessary to support this evaluation. At a minimum, such a letter must be signed by the chair of the audit committee. An audit committee's refusal to furnish written representations constitutes a scope limitation.

Because we agree that an effective audit committee is an important element of the control environment, we also believe that management should be required to assess the audit committee as part of its assessment of the overall control environment. Accordingly, the PCAOB should require that the auditor obtain from management its assessment of the audit committee and consider that assessment in forming the auditor's opinion.

Finally, in response to question 24, we strongly believe it would be a disservice to investors and to the public to require the auditor to withdraw from an audit engagement because the auditor has concluded that the audit committee is ineffective. The auditor always has the option to withdraw from an engagement. Requiring that action, however, does not appear to be in anyone's interest. The auditor could still express an unqualified opinion on the financial statements. Furthermore, the communication of the material weakness(es) that resulted in the adverse opinion is useful information to the public.

Walkthroughs

We believe walkthroughs have always been an important part of the auditor's evaluation of internal control. We therefore support the PCAOB's requirement that the auditor perform walkthroughs "for all of the company's significant processes."

However, the requirement that the auditor "should trace *all* types of transactions and events, both recurring and unusual, from origination through the company's information systems until they are reflected in the company's financial reports" appears to be an additional requirement which is separate from the discussion of significant processes and which is unnecessarily onerous given that it potentially encompasses hundreds of immaterial types of transactions and events. As stated later in this letter in the discussion of the use of the term "all," a requirement related to all of a population by its nature excludes any consideration of materiality, removes auditor judgment, and will be costly to implement with little incremental benefit. We do not believe the auditor needs to walk through every immaterial or insignificant event and transaction within a significant process in order to identify risks that could create a material misstatement of the financial statements.

Furthermore, we do not believe the concept of significant processes that appears in paragraph 79 is consistent with that in paragraph 69. Paragraph 69 states that "the auditor should identify each significant process over each major class of transactions affecting significant accounts or groups of accounts." This suggests that the processes that are of concern to the auditor are those that are both significant and also are related to major classes of transactions affecting significant accounts or groups of accounts. We believe that this guidance is appropriate. The discussion of significant processes in paragraph 79, however, seems to have lost the notion of relatedness to major classes of transactions affecting significant accounts or groups of accounts. We believe that the guidance in paragraph 79 should be clarified and made consistent with that in paragraph 69.

In order to achieve the objectives described in paragraph 79, we believe that the auditor should perform independent walkthroughs for all the company's significant processes and for *significant* events and transactions. We do not believe the auditor should be required to perform independent walkthroughs for insignificant events and transactions.

Consideration of Management's Extent of Testing

There is considerable confusion among issuers about the extent of testing that management must perform in order to obtain sufficient evidence to support management's assessment. There appears to be a wide range of views among issuers as to what the appropriate levels of testing should be, including how monitoring controls and other aspects of the control environment affect the extent of testing. We believe that the PCAOB should work with the SEC to develop some definitive guidance for preparers. Furthermore, such guidance needs to make it clear that the auditor's testing cannot be used as the basis for management's assertion about the effectiveness of internal control.

In general, and as it relates to control activities in particular, we believe that management's extent of testing needs to be, *at a minimum*, at the same level as the auditor's in order for management to have sufficient evidence to provide a basis for its assessment. This concept needs to be applied on an overall basis. It should recognize that the controls tested and the nature of tests might differ, however, management's testing needs to provide the same level of reasonable assurance that is required of the auditor, and therefore the level of evidence to support management's assessment should be at least equal to the level of evidence obtained by the auditor.

Paragraph 125 of the proposed standard states:

> Inadequate documentation of the design of controls *and the absence of sufficient documented evidence to support management's assessment of the operating effectiveness of internal*

> *control over financial reporting* [italics added] also are internal control deficiencies. As with other internal control deficiencies, the auditor should evaluate these deficiencies as to their significance.

We believe that the above guidance should be expanded to address the extent of testing. We also believe that the proposed standard should require that the absence of sufficient evidence to support the responsible party's evaluation of the operating effectiveness of internal control constitutes either a significant deficiency or a material weakness because the monitoring component of internal control cannot be demonstrated in the absence of sufficient evidence to support management's assertion. Accordingly, we believe that the absence of sufficient evidence to support management's assessment should be added to the list of circumstances in paragraph 126 that is a strong indicator of a material weakness.

Considerations for Small and Medium-Sized Issuers

Page 6 of the introductory discussion in the proposed standard states:

> The Board is sensitive to the possible effects of the proposed standard on small and medium-sized companies . . . For a smaller, less complex company, the Board expects that the auditor will exercise reasonable professional judgment in determining the extent of the audit of internal control and perform only those tests that are necessary to ascertain the effectiveness of the company's internal control.

We agree with this statement because we believe that, *regardless of entity size and complexity*, the auditor should exercise reasonable professional judgment in determining the extent of the audit of internal control and perform only those tests that are necessary to ascertain the effectiveness of the entity's internal control. We are concerned, however, that the PCAOB's statement above will create an expectation among smaller issuers that the auditor should apply to audits of smaller entities a lower standard concerning sufficiency of evidence. Appendix E also appears to create a lower standard of internal control for smaller issuers that may be inappropriately interpreted by some as a justification for giving inadequate attention to their assessment of internal control.

Appendix E focuses primarily on the lack of formality in implementing various components of internal control at smaller companies. While this may be valid, the examples that are given fail to describe sufficiently what kinds of controls are likely to be different in smaller issuers, and importantly, what kinds of compensating controls can smaller issuers implement to overcome potential control deficiencies. For example, paragraph E9 suggests that a "CFO's careful review of daily sales and key ratios might be just as effective in a small company as lower level control activities that might be found in a larger business." We do not believe that such a review is an adequate compensating control that would appropriately address all relevant financial statement assertions. Additionally, we believe the discussion throughout Appendix E substantially overemphasizes the benefits of direct interaction by senior management with employees in smaller entities as a compensating control.

Paragraph 27 states that:

> . . . the auditor must 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.

We believe that the above requirement or objective applies to small, medium-sized, and large issuers. It is important for the auditor to understand the difference of auditing internal control over financial reporting in a smaller less formal setting than a highly complex large organization. However, we believe the proposed guidance does not adequately emphasize that the auditor of small entities is still required to meet the objective of paragraph 27 and to evaluate design and operating effectiveness for all relevant assertions for all significant accounts and disclosures.

Finally, Appendix E provides *no* guidance on how the auditor might tailor his or her procedures for smaller issuers. Some examples of how this may be done and still meet the objective set forth in paragraph 27 would be helpful.

Safeguarding of Assets

The guidance in Appendix C of the proposed standard should be significantly enhanced. As currently written, it is not sufficient to answer the questions that are arising in practice about which controls over safeguarding of assets are within the scope of internal control over financial reporting, and which are not. Following are several examples where it would be difficult to conclude, using the guidance provided in Appendix C, that management or the auditor should be concerned about the effectiveness of the controls related to safeguarding the selected assets.

Retail Inventory Shrinkage. A retail client has made a cost-benefit decision not to install theft prevention techniques (for example, tagged clothing and security devices at entrances) in their retail stores. Actual shrinkage in each store ranges from 5-10 percent of inventory on a monthly basis. Are the controls related to theft prevention part of internal control over financial reporting? If so, does the lack of controls over inventory shrinkage represent a significant deficiency or a material weakness if management takes a quarterly physical inventory and properly records the shrinkage?

Music Piracy. The auditor has a client that produces music for sale on CDs. Customers copy the CDs and make them available over Internet sites that allow for file swapping. Technology exists that allows the CDs to be encrypted in such a way that they cannot be copied. Management makes a decision not to encrypt the CDs because they do not want to alienate their customers.

Does management's decision not to encrypt the CDs (and thus not protect the related asset – music) fall within internal control over financial reporting? If so, does it represent a significant deficiency or a material weakness?

Disaster Recovery. A client has made a cost-benefit decision not to provide controls for adequate disaster recovery. Is management's decision not to provide disaster recovery controls part of internal control over financial reporting? If so, does it represent a significant deficiency or a material weakness? If it is an internal control over financial reporting, how would management and the auditor test disaster recovery?

Insurance Underwriting. Do the controls over accepting risk and pricing an insurance policy fall into controls related to financial reporting? These controls affect the level of risk and therefore the balance sheet reserves required, however, the company has strong controls over setting loss reserves and those controls take into account the level of controls that exist over the underwriting process. Does the lack of such controls represent a significant deficiency or a material weakness?

We believe that none of the examples would be a significant deficiency or a material weakness. The definitions of both significant deficiency and material weakness require there be more than a remote likelihood that a misstatement of the annual or interim financial statements will not be prevented. In the retail and insurance underwriting examples, the company has a detective control (quarterly physical inventories, controls over setting loss reserves, and monthly bank reconciliations) to ensure that the financial statements are not misstated. The music piracy issue and the lack of a formal disaster recovery policy do not result in a misstatement of the financial statements.

Based on the proposed definitions, we do not believe an ineffectiveness issue could be raised in any of the above scenarios since an ineffective system of internal control results only when a material weakness exists, and in these cases no deficiency exists that could cause the financial statements to be misstated. If the PCAOB concludes that these types of controls *do* fall within the definition of internal control over financial reporting, and the lack of such controls results in an ineffective system of internal control over financial reporting, we believe the PCAOB should modify its proposed definitions of internal control deficiency, significant deficiency, and material weakness to be consistent with that conclusion.

Service Organizations

We believe the PCAOB should revise the guidance on service organizations that appears in Appendix B of the proposed standard to clarify how it relates to the Board's existing interim standard, *Service Organizations*. Some of the guidance from the interim standard has been paraphrased or described using different wording. As a result, it is not clear whether the Board intended to change the interim standard and just omitted any mention of such changes from the introduction to the proposed rule (see our comment above entitled "Process for Identifying and Communicating Changes to Various Interim Standards"). In addition, we believe the Board should significantly enhance the guidance on what the auditor should do, and what management should do, when the company uses a service organization as part of its internal control.

Use of "All"

The proposed auditing standard significantly increases various requirements for auditors to perform a procedure for "all" of a specific item. By its nature, a requirement related to all of a population excludes any consideration of materiality, removes auditor judgment, and will be costly to implement. Consideration must be given to whether the benefits to be achieved outweigh the cost of such requirements. In addition, we are concerned that in some instances the proposed guidance is establishing a threshold for the auditor that may be unachievable because the auditor's testing is generally selective. Requiring the auditor to perform a procedure for "all" of a population also inappropriately removes the auditor's ability to apply his or her professional judgment to the unique facts and circumstances of an audit engagement. The following are examples of paragraphs where we believe the word "all" (identified in boldface italics) needs to be reconsidered to ensure the requirements do not exceed the benefits obtained and result in the auditor performing procedures that would not result in discovery of material weakness in internal control over financial reporting.

79. In a walkthrough, the auditor should trace ***all*** types of transactions and events, both recurring and unusual, from origination through the company's information systems until they are reflected in the company's financial reports. (Also see the discussion of walkthroughs earlier in this letter)

114. As part of this evaluation, the auditor should review ***all*** reports issued during the year by internal audit (or similar functions, such as loan review in a financial institution) that address controls related to internal control over financial reporting and evaluate any internal control deficiencies identified in those reports.

191. In addition, the auditor should communicate to management, in writing, ***all*** deficiencies in internal control over financial reporting (that is, those deficiencies in internal control over financial reporting that are of a lesser magnitude than significant deficiencies) identified during the audit and inform the audit committee when such a communication has been made. (Also see our response to question number 20)

Indicators of Material Weakness

We agree with the guidance in paragraph 126 of the proposed standard that a restatement of previously issued financial statements to reflect the correction of a misstatement is at least a significant deficiency and is a strong indicator that a material weakness in internal control over financial reporting existed at that time. However, the subsequent discovery of a material misstatement of the financial statements, or of a material weakness in internal control, is not, in and of itself, evidence of (*a*) failure to obtain reasonable assurance; (*b*) inadequate planning, performance, or judgment; (*c*) the absence of due professional care; or (*d*) a failure to comply with PCAOB standards. Given the inherent limitation of an audit as described in paragraph 15 of the proposed standard, absolute assurance is not possible. Therefore, we believe the proposed standard should include the following statement: “Since the practitioner’s opinion on internal control is based on the concept of obtaining reasonable assurance, the practitioner is not an insurer and his or her report does not constitute a guarantee.”

Effective Date

We understand that the PCAOB’s effective date for the proposed standard is based on the date established by the Securities and Exchange Commission for implementation by registrants of its final 404 rule.

Nonetheless, we do not believe it is realistic to require implementation by accelerated filers of the internal control reporting and disclosure requirements of Section 404 of the Act for fiscal years ending in June, July, or August of 2004. Under the best of circumstances, we do not believe this proposed standard can be issued as a final document before early 2004. Since management as well as auditors are looking to this guidance to undertake what is a significant new approach to the audits of public companies, we do not believe that a time frame that is less than six months is sufficient to implement these requirements. In addition to the lack of final guidance, many implementation questions will need to be addressed by both management and the auditor. Time will be required to surface, resolve, and provide guidance on these issues. Accordingly, we believe that the effective date should be extended to audits of financial statements for fiscal years ending on or after September 15, 2004.

Authoritative Appendices

The Statement of Authority at the beginning of the proposed standard states that “appendices to the Board’s standards are an integral part of the standard and carry the same authoritative weight as the body of the standard.” We believe that the PCAOB should clarify whether this statement applies to the appendices in the Board’s interim transitional standards.

We also recommend that the PCAOB clarify whether examples in the appendices are intended to establish requirements, or to provide illustrative guidance to be used by the auditor in making judgments about similar circumstances. For example, paragraph D3 states: “The following examples illustrate how to evaluate the significance of internal control deficiencies in various situations. These examples are for illustrative purposes only.” However, each of the scenarios in Appendix D has a conclusion that states, “based only on these facts, the auditor *should determine* that this deficiency represents a significant deficiency [material weakness] for the following reasons” (italics added). The “should determine” language is inconsistent with the statement in paragraph D3 that the examples are for illustrative purposes only.

Responses to Questions

Questions regarding an integrated audit of the financial statements and internal control over financial reporting:

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?**

   It is appropriate to refer to the auditor’s attestation as an audit. The auditor’s objective is to express an opinion on management’s assertion about the effectiveness of internal control over financial reporting, just as the auditor’s objective in an audit of the financial statements is to express an opinion on the financial statements. The level of assurance provided by the auditor’s opinion is the same for either engagement. The requirement to obtain sufficient competent audit evidence to support the opinion is the same for either engagement. Only the subject matter on which the opinion is expressed is different.

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?

We agree that for public company audits, the auditor should be prohibited from performing an audit of internal control over financial reporting without also performing an audit of the financial statements.

The applicability of the proposed standard and the continuing applicability of AT section 501 needs to be clarified. The first sentence of paragraph 2, on its own, does not appear to be correct since not all companies subject to the reporting requirements of the Securities Exchange Act of 1934 are required to report on internal control over financial reporting. Furthermore, footnote 1 states that "this standard supersedes AT section 501 as it relates to performing an audit of the design and operating effectiveness of internal control over financial reporting." Does that mean that AT section 501 is superseded, or that it is superseded only with respect to some guidance? Should public companies not subject to section 404 of the Sarbanes-Oxley Act but that voluntarily wish to obtain an auditor attestation of internal control use the proposed standard or AT section 501?

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?

No. Requiring something less would be difficult to define and would result in significant inconsistencies in practice for public company audits. We also agree that the audit of internal control and the audit of financial statements should be completed as of the same date.

Question regarding the costs and benefits of internal control:

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?

See comment above entitled "Considerations for Small and Medium-Sized Issuers."

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.

The PCAOB's interim standards require that the person or persons performing the engagement have adequate technical training and proficiency as an auditor (or in the attest function) and adequate knowledge of the subject matter, and that work is to be properly supervised. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312.17), further states:

> Whenever the auditor has concluded that there is significant risk of material misstatement of the financial statements, the auditor should consider this conclusion in determining the nature, timing, or extent of procedures; assigning staff; or requiring appropriate levels of supervision. The knowledge, skill, and ability of personnel assigned significant engagement responsibilities should be commensurate with the auditor's assessment of the level of risk for the engagement. Ordinarily, higher risk requires more experienced personnel or more extensive supervision by the auditor with final responsibility for the engagement during both the planning and the conduct of the engagement.

We believe the existing interim standards are adequate. We do not believe that it is realistic to mandate levels of experience for the performance of specific procedures because development of personnel does not progress on a uniform timetable. We believe appropriate judgment needs to be made around staffing assignments and it would be inappropriate to specify the level of staff for specific audit procedures.

Questions regarding evaluation of management's assessment:

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, we believe that for public companies it is appropriate that the scope of the audit requires the auditor to both evaluate management's assessment and obtain, directly, evidence about whether internal control over financial reporting is designed and operating effectively, as stated in paragraph 5 of the proposed standard.

We also believe that the auditor's opinion in report Examples A-1 and A-6 should run directly to the effectiveness of internal control over financial reporting rather than to management's assessment both to be consistent with the scope paragraph in those reports and to eliminate any confusion that the auditor is expressing an opinion on the effectiveness of internal control over financial reporting. Accordingly, we believe that report element "l" in paragraph 153 should be changed to read "the auditor's opinion on whether the company maintained, in all material respects, effective internal control over financial reporting as of the specified date based on the control criteria" so that it is consistent with report element "h."

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

Yes. It is appropriate to provide criteria. However, we believe the Board needs to clarify paragraph B-3 of the proposed standard. Does the guidance in B-3 mean that management would not be required to have controls documented at locations or business units that are not able to create, either individually or in the aggregate, a material misstatement? We believe that management should have at least a minimum level of documentation of controls at these locations or business units consistent with the requirement that registrants must maintain adequate books and records.

We also believe more guidance is needed in the area of documentation of locations or business units that individually are insignificant but when aggregated could result in a material misstatement. We believe management should be required to document all significant controls at these locations as it relates to the significant accounts at the consolidated financial levels. Without appropriate documentation, we do not believe management can demonstrate adequate company wide controls since documentation of controls is a foundation of company wide controls.

Further, as part of providing criteria that auditors should use to evaluate the adequacy of management's documentation, we believe that the Board, in conjunction with the SEC, should address the matter of management's level of documentation and retention of documentation as well as the auditor's documentation of the entity's systems and controls.

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?

We do not believe inadequate documentation should automatically rise to the level of a significant deficiency or a material weakness. The effect of inadequate documentation is a judgmental matter to be considered in the auditor's evaluation of internal control over financial reporting.

Paragraph 46 states that "in evaluating the deficiency as to its significance, the auditor should determine whether management can demonstrate the monitoring component of internal control over financial reporting in the absence of documentation." This language suggests that there are ways in which management can demonstrate the monitoring component in the absence of documentation of controls. We believe there needs to be clarification around this statement and if this statement is retained, examples of how management would do this should be provided. We believe that documentation provides the foundation for the entity's evaluation of and monitoring of the effective operation of controls.

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?

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 comment above entitled "Walkthroughs."

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?

We believe that the auditor needs to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year. Reliance on prior year work is inappropriate.

We do not, however, believe that this requirement is clearly stated in the proposed standard. Paragraph 101 of the proposed standard states:

> Each year the auditor must obtain sufficient evidence about whether the company's internal control over financial reporting, including the controls for all internal control components, is operating effectively. The auditor also should vary from year to year the nature, timing, and extent of testing of controls to introduce unpredictability into the testing and respond to changes in circumstances. For example, each year the auditor might test the controls at a different interim period; increase or reduce the number and types of tests performed; or change the combination of procedures used.

We believe that the guidance in the above paragraph does not make it clear that the auditor is required to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year, without using some of the audit evidence obtained in previous years to support his or her current opinion on management's assessment. The guidance in the proposed standard should be stated as explicitly as question 11 so that it is clear to auditors.

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?

Allowing the auditor to rely on certain testing performed by management should be permitted but not required. It should be based on the auditor's judgment of the competence and objectivity of those performing the work, and subject to the overall requirement that the auditor should obtain the principal evidence for the opinion.

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

Paragraph 104 of the proposed standard states that areas in which the auditor should not use the work of others includes "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." Internal auditors in many companies possess both the skills and the objectivity to perform tests of IT general controls very effectively. We believe that to prohibit using the work of such professionals altogether would result in a costly redundancy of work effort between the company and the auditor that provides no benefit. Accordingly, we strongly believe that controls that have a pervasive effect on the financial statements, such as IT general controls, should be included among the areas of controls discussed in paragraph 105 where the auditor's use of the results of procedures performed by others should be limited, but not prohibited.

With regard to the areas in which the work of others should be limited (paragraph 105), we believe the PCAOB should provide additional guidance to clarify the meaning of "limited."

In paragraph 106, the phrase "without specific limitation" does not clearly communicate what level of auditor involvement is appropriate in areas such as controls over routine processing of significant accounts and disclosures. Does this imply the auditor would not necessarily be required to do some testing of each control in this category? We believe that the auditor needs to perform some tests in the areas described in paragraph 106 because it is inappropriate to rely exclusively on the results of tests performed by others. See also our response to question 15.

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?

We do believe that the proposed standard gives appropriate recognition to the work of internal auditors in paragraph 108. The guidance in paragraph 108 supports our response to question 13 as it relates to using the results of tests of IT general controls performed by internal auditors.

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)?

Paragraph 107 states that if the auditor intends to use the work of others, "the auditor should reperform some of the tests of controls originally performed by others." We believe more guidance is needed here to indicate if reperformance must be done at each individual control level, the account balance level, or just on an overall basis.

In addition, it is not clear whether the guidance in paragraph 107 is intended to apply to both paragraphs 105 and 106 or only to paragraph 105.

16. Is the requirement for the auditor to obtain the principal 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?

Yes, the requirement in paragraph 109 that "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" is an appropriate benchmark for the amount of work that is required to be performed by the auditor. However, we believe the following guidance should be added to paragraph 109: "Because controls over certain areas are not always susceptible to mathematical measurement, the auditor will need to apply judgment to determine that he or she has obtained the principal evidence from his or her own testing."

Questions regarding evaluating results:

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?

We recognize how difficult it is to develop a meaningful definition of internal control deficiency that can be understood and applied consistently. The AICPA's Auditing Standards Board task force spent significant time in its own deliberations on this subject. We believe the definitions included in the proposed standard provide a reasonable level of clarity that would provide a more consistent application. However, we believe by including the probability concept of "remote" in the definition of significant deficiency, the PCAOB has lowered the threshold and as a result will increase the number of deficiencies that will be classified as significant deficiencies. Although the number of deficiencies is not of major concern to us, what does concern us is that the number may ultimately dilute the importance of significant deficiencies and, as a result, cause management, audit committees, boards of directors, and others to view this category as irrelevant or unimportant. At the same time, requiring unresolved significant deficiencies to be strong indicators of a material weakness would capture significant deficiencies when the likelihood of a misstatement is slightly more than remote (for example, a 5-8 percent likelihood) and the amount of misstatement is slightly more than inconsequential (for example, more than 1 percent). Doing so seems inappropriate and could result in adopting controls that far exceed the benefit. We believe the Board needs to evaluate if it intended to have these consequences when applying the proposed definitions and consider removing the concept of "remote" from the definition.

We also note that in the report Examples A-2 and A-3, the definition of significant deficiency in the explanatory paragraphs includes only the part of the definition that states that "a significant deficiency is an internal control deficiency that adversely affects the company's ability to initiate, record, process, and report external financial data reliably in accordance with generally accepted accounting principles." We do not believe that this definition will be meaningful to users of the report since it does not communicate anything about the materiality or the likelihood of the deficiency, in contrast to the definition of material weakness.

In addition, we think the Board should change the definition of significant deficiency to read "A significant deficiency *is*" rather than "A significant deficiency *could be*" so that the construction is parallel to the definition of material weakness. Finally, we believe the Board should drop the words "in amount" following "more than inconsequential," since we believe the determination of what is "more than inconsequential," just as well as what is "material," could involve qualitative as well as quantitative considerations.

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?

We believe the examples are helpful in providing some clarity around the application of the definition. However, they are reasonably straightforward (black and white) situations. The difficulty will come in the gray areas. Additional examples should be provided where deficiencies would not meet the threshold of "more than remote" and less obvious examples and conclusions are needed.

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

Yes. Once the auditor becomes aware of an internal control deficiency, the auditor needs to evaluate whether it is a significant deficiency or a material weakness.

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?

We believe it is appropriate to require the auditor to communicate to management all deficiencies in internal control (that is, those deficiencies that are of a lesser magnitude than significant deficiencies) that were identified by the auditor during the audit.

However, paragraph 191 goes beyond communication of deficiencies identified by the auditor and includes all deficiencies identified by management, internal auditors, or others. In large multi-national companies this could amount to hundreds, even thousands, of comments that do not reach the level of significant deficiency and would create a level of effort that would far exceed the benefits. We believe that management should be expected to be responsible for accumulating these comments as part of its overall monitoring function. It is inappropriate for the auditor to play this role.

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

As stated earlier, we believe that the absence of sufficient evidence to support the responsible party's evaluation of the operating effectiveness of internal control would result in a strong indicator of material weakness. We believe that this matter should be added to the list in paragraph 126 and deleted from paragraph 125.

While we agree that an ineffective regulatory compliance function may result in a material misstatement in the financial statements, there are many aspects of the function that by themselves may be ineffective without affecting the financial statements. Singling out the entire function will lead to confusion regarding whether the regulatory process falls within the definition of internal control over financial reporting. We believe each deficiency within the regulatory function first needs to be evaluated to determine if it applies to internal control over financial reporting. If it does, then it should be evaluated to determine whether it is a significant deficiency or a material weakness.

We agree fraud on the part of senior management is a serious issue, however, we do not believe it is the responsibility of the auditor to identify fraud of any magnitude. We also do not believe that fraud of any magnitude would necessarily constitute a significant deficiency or a material weakness, particularly in situations where the company's controls uncovered the issue. We also do not believe that the auditor should be required to consider issues that occur outside the company's environment such as filing a false tax return.

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?

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

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?

See comment above entitled “Evaluating the Effectiveness of the Audit Committee’s Oversight.”

Questions regarding forming an opinion and reporting:

25. Is it appropriate that the existence of a material weakness would require the auditor to express an adverse conclusion about the effectiveness of the company's internal control over financial reporting, consistent with the required reporting model for management?

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

27. Do you agree with the position that when the auditor issues a non-standard opinion, such as an adverse opinion, that the auditor's opinion should speak directly to the effectiveness of the internal control over financial reporting rather than to whether management's assessment is fairly stated?

See comment above entitled “Forming an Opinion and Reporting.”

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?

No. We do not believe that this proposed standard is the appropriate place for guidance on independence and internal control-related non-audit services.

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

We believe that the non-audit services currently prohibited for audits of issuers are appropriate and that no additional rules are necessary.

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?

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

As in financial statement reporting, we believe differing levels of responsibility are appropriate.

We believe paragraphs 8 and 9 of the proposed standard may imply that the auditor is obligated to identify deficiencies that could result in a misstatement to interim financial statements. We do not believe that an auditor should be required to plan his or her annual audit of internal control to consider materiality or tolerable errors at the materiality level of the interim financial statement. Therefore, we believe the PCAOB needs to be explicit that this is not required or state what they believe is required relative to the existing model (that is, SAS 100).

In addition, we believe that the language in the second bullet of paragraph 186 should be changed from “whether significant changes in internal control over financial reporting may introduce significant deficiencies or material weaknesses in the design of internal control over financial reporting” to “whether any change in internal control over financial reporting has materially affected, or is reasonably likely to materially affect, the company’s internal control over financial reporting” to conform to wording in the SEC's final 404 rule. We do not believe that the auditor's responsibility should be extended beyond that required for management.

Finally, we believe the auditor evaluation responsibilities described in paragraphs 185 through 189 should not be required until the first quarter after the company's issuance of its first annual 404 report.

Additional/Editorial Comments

1. The proposed standard should include guidance on the work that is required of the auditor to determine whether an identified deficiency in one interim period has been corrected in a subsequent interim period. Since the auditor has no responsibility to do testing on a quarterly basis, what would be the basis for the auditor to conclude that the control is now designed and operating effectively?

2. In regard to paragraph B15 of the proposed standard, we believe that the internal control of all equity investees should be excluded from the company's evaluation of internal control over financial reporting, except with regard to controls over accounting for these investments in accordance with generally accepted accounting principles. Therefore, we believe the word "ordinarily" should be eliminated from the statement that "the evaluation *ordinarily* [italics added] would not extend to controls at the equity method investee." However, if it is not eliminated, we believe an example should be provided of a situation where the evaluation of the company's internal control would extend to controls at an equity method investee.

3. In paragraph 2, change the beginning of the fourth sentence to either "the audit firm that audits" or "the auditor who audits."

4. Although we agree with the statement, the last sentence of paragraph 11 seems misplaced.

5. Although we agree with the statement, the last sentence of paragraph 36 seems off point in that it doesn't tie back to the discussion of professional skepticism.

Thank you for the opportunity to comment on this proposed standard. We would be pleased to meet with PCAOB members and staff to discuss our comments.

Sincerely,

S. Scott Voynich, CPA
Chairman of the Board

Barry C. Melancon, CPA
President and CEO

American Society of Corporate Secretaries

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

Dear Board Members:

The American Society of Corporate Secretaries, Inc. ("Society") is a professional association founded in 1946, serving more than 4,000 corporate attorneys and other business executives who represent over 3,000 companies. The members' major duties include working with corporate boards of directors to improve corporate governance; assuring company compliance with securities regulations; coordinating activities of stockholders, including proxy voting for the annual meeting of shareholders; and administering other activities handled by the Corporate Secretary's Office. The majority of the Society's members are attorneys.

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements (the "Proposed Standard"). The Proposed Standard covers attestation engagements under Sections 404(b) and 103(a)(2)(A) of the Sarbanes-Oxley Act of 2002 (the "Act").

First, the Society would like to make general comments about its perception of the approach that the Proposed Standard seems to be taking. Then we would like to address selected topics of particular interest to our members: External auditors' oversight of the effectiveness of audit committees; communications among external auditors, management and the audit committee; the ability of external auditors to rely on the work of others, especially internal audit; the introduction of new terminology; and the characterization of the external auditors' attestation opinion.

*** * * * ***

General

We applaud the PCAOB for being sensitive to the fact that internal control over financial reporting cannot be "one-size-fits-all." However, as a general comment, we would like to note that the Proposed Standard takes away much of the professional judgment and expertise that external auditors could bring to the assessment of internal controls over financial reporting in a given factual situation. We recommend that the Board allow external auditors to exercise their judgment to a greater extent than currently contemplated under the Proposed Standard.

Oversight of Effectiveness of Audit Committees

Section 301 of the Act states that "[t]he audit committee . . . shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by the issuer . . . and each such registered public accounting firm shall report directly to the audit committee . . . ." Paragraphs 56-59 of the Proposed Standard require the external auditors to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting.

Conflict of Interest. We believe that Paragraphs 56 – 59 create an unworkable conflict of interest for the external auditors. Paragraph 59 of the Proposed Standard states that "[i]neffective oversight by the audit committee of the company's external financial reporting and internal control over financial reporting should be regarded as at least a significant deficiency and is a strong indicator that a material weakness in internal control over financial reporting exists." Paragraph 57 states that the external auditor should evaluate the "Committee's compliance with applicable listing standards adopted pursuant to Section 301 of the Act." Major new laws, rules and standards have arisen from numerous regulatory fronts affecting both issuers and their external auditors. One of the audit committee's primary responsibilities is to retain, terminate and determine the compensation paid to external auditors. In its final listing standards' discussion on the role of audit committees, the New York Stock Exchange ("NYSE") states that one of the committee's purposes is to "assist board oversight of… the independent auditor's qualifications and independence. We believe this critical responsibility and oversight function of the audit committee is incompatible with, and would be compromised by, an evaluation of the audit committee by the external auditors under the Proposed Standard.

Scope of External Auditors' Evaluation. The Proposed Standard gives as examples seven factors that the external auditor should consider in evaluating the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting. With due deference to the professionalism and expertise of external auditors, some of the proposed factors venture into the realm of what the Securities and Exchange Commission (the "SEC") and the stock exchanges are addressing, not matters inherently within the expertise of external auditors. For instance, paragraph 58 of the Proposed Standard states that "[a]s part of evaluating the independence of committee members, the auditor should evaluate how audit committee members are nominated and selected and whether they act independently from management . . . For example, are qualified candidates identified by outsiders, such as an outside search firm or a nominating committee composed of outside directors, . . . ?"

We strongly recommend that the PCAOB defer to Section 303A.4(b) of the NYSE's final listing standards as approved by the SEC on November 4, 2003, which states that the nominating committee's purpose and responsibilities at a minimum must be to "identify individuals qualified to become board members, consistent with criteria approved by the board, and to select, or to recommend that the board select, the director nominees for the next annual meeting of shareholders . . . ." There are mechanisms to monitor and enforce the listing standards.

We note that, as a result of the Proposed Standard, external auditors are now planning significant audit procedures including lengthy surveys and interviews with audit committee members to fulfill this evaluation requirement. Given the existence of the NYSE listing standards addressing board and committee nominees and their independence, we believe that any added benefit of the external auditors also reviewing directors' independence would be immaterial and unnecessary, particularly when balanced against the significant added burden of the extra audit procedures.

Communications

Paragraph 191 of the Proposed Standard requires the external auditor to communicate "to management, in writing, *all* [emphasis supplied] deficiencies in internal control over financial reporting (that is, those deficiencies in internal control over financial reporting that are of a lesser magnitude than significant deficiencies) identified during the audit . . . ." In addition, the external auditor must "inform the audit committee when such a communication has been made." This provision would require a change from external auditors' current practice of communicating significant deficiencies (reportable conditions) and material weaknesses in writing to the audit committee to an approach that would require communication to management of **all** deficiencies in internal controls over financial reporting identified during the audit and to inform the audit committee when a communication has been made.

The probable result is that most audit committees will feel that they cannot simply take on its face the fact that the external auditor reported deficiencies to management without exploring further. Instead, audit committees are likely to feel compelled to ask about the substance of all the deficiencies. What may then happen is that the committee will become bogged down in reviewing insignificant matters rather than focusing on topics of greater importance to the company and its owners. Accordingly, we recommend that the PCAOB retain the current reporting structure.

Reliance on Work of Others, Especially Internal Audit

The Society appreciates the PCAOB's recognition of the expense and work incurred by companies: "[t]he more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be." It seems to recognize that the external auditor can rely on the work of internal audit in certain areas: "The proposed auditing standard . . . would allow the auditor to incorporate into the audit . . . some of the work performed by others, such as internal auditors or third parties . . . ."

However, other provisions limit the circumstances in which internal audit may be used. The draft proposes that internal audit *cannot* be used for the following areas:

- Control environment, including fraud controls.
- Controls over period-end financial reporting process.
- Controls that have a pervasive effect on the financial statements, such as certain IT general controls on which the operating effectiveness of other controls depend.

- Walkthroughs.

These prohibited functions are some of the key areas in which an internal audit group can provide significant insight and audit evidence based on its experience with the company. Public companies do not expect external auditors to rely solely on internal audit for 100% of testing. Eliminating internal audit from these critical areas, however, is a dramatic change from present accepted practices. In addition, this proposed point does not allow the external auditors latitude to use their own professional judgment. For example, in the new "walkthrough" concept that the Proposed Standard introduces, it is not clear if all processes in all locations (significant or otherwise) must have a walkthrough. Multinationals with complex global operations could have hundreds of processes located in numerous geographies involving multiple sites. We believe that external auditors should be allowed to use their judgment, taking into account the specific circumstances of the company, to determine the operating effectiveness of controls for all relevant assertions for all significant accounts and disclosures.

The proposed auditing standard also would require that, overall, the external auditor obtain directly the "principal evidence" about the effectiveness of internal control over financial reporting. It is our understanding that many external auditors are interpreting the Proposed Standard to mean that only they can provide the principal evidence. The result is significant increased costs to companies, without necessarily any more benefits going to the investing public. For all companies, small, mid-sized and large, the additional costs are likely to be very high. Anecdotally, our members report that their external auditors have told them to expect 25-100% fee hikes to cover internal control work.

Unfortunately, one unintended consequence if the Proposed Standard is adopted in this area will be to diminish or eliminate the role of internal audit. In its final listing standards, the NYSE reaffirmed the importance of internal audit by requiring that all listed companies have an internal audit function, a stance we urge the PCAOB to support. Effectively decimating strong internal audit functions will diminish, not enhance, the ability of corporations to maintain a strong control environment from which management can produce transparent financial statements with integrity that will inspire investor confidence.

Introduction of New and Broad Terminology

While we appreciate the Board's efforts to clarify the definition of "significant deficiency," which is not currently well defined in the auditing literature, we believe the Board's proposed definitions of both "significant deficiency" and "material weakness" capture an unnecessarily low and insignificant level of control deficiencies which were not within the intent of Congress when it adopted the Act. These new definitions also introduce significant ambiguities that make it difficult for companies or external auditors to interpret and apply the definitions. As an alternative to the Board's approach, we recommend the Proposed Standard give companies and the external auditors latitude to exercise judgment in determining those deficiencies that are significant enough to be elevated to management and the audit committee, or disclosed in public filings, while using more well-established terminology to provide definitional guidance. Rather than introducing the term "inconsequential" in the significant deficiency definition, we recommend that the Board use the well-understood concept of materiality in addressing the magnitude of both a significant deficiency and a material weakness, and use different degrees of likelihood to distinguish between the two. Specifically, we recommend that the definitions hinge on whether there is a reasonable possibility that individual or aggregated deficiencies would lead to a material adjustment in the financial statements, in the case of significant deficiencies, and on whether it is reasonably likely the deficiencies would lead to a material adjustment in the financial statements, in the case of material weaknesses. Using terminology that is already well interpreted in the auditing literature, SEC guidance and judicial decisions will give companies and auditors greater ability to apply the definitions in exercising their judgment.

In addition, we ask that the Board avoid using terminology that appears to extend beyond the financial reporting controls scope of the SEC's rules. For instance, ineffective internal audit, risk assessment, and regulatory compliance functions are listed as examples of significant deficiencies. Yet in many companies, these functions extend beyond the realm of internal controls over financial reporting.

Characterization of Qualified Attestation

The Proposed Standard, in Paragraphs 177-179 discusses situations where there is an adverse opinion on the effectiveness of internal controls over financial reporting due to a material weakness but the auditor's opinion on the financial statements is unqualified because they were able to perform substantive procedures to satisfy themselves that there was no material misstatement in the financial statements. Paragraph 178 proposes the inclusion of qualifying language in the report on internal control over financial reporting explaining that the material weakness does not impact the audit report on financial statements. We are concerned that the appearance of an unqualified opinion on the financial statements alongside an *adverse* opinion on the effectiveness of internal control over financial reporting due to a material weakness that did not result in a material misstatement in the financial statements will create the perception to the investing public that the financial reports are unreliable despite the inclusion of the qualifying language in the report on internal control over financial reporting. We recommend that the external auditor be allowed to exercise judgment as to whether the opinion on the effectiveness of internal control over financial reporting should be regarded as a *qualified* opinion rather than an *adverse* opinion based upon the materiality of the weakness and scope limitations if any.

* * * * *

The Society’s members vigorously support the accountability of management for establishing and maintaining adequate internal controls over financial reporting. We hope that the Proposed Standard will permit companies and their owners to take full advantage of the professional and thorough work and expertise of management and internal audit. We also hope that external auditors are permitted to exercise their considerable professional expertise and judgment. If not, we risk violating the PCAOB’s sensitivity that “internal control is not ‘one-size-fits-all,’ and the nature and extent of controls that are necessary depend, to a great extent, on the size and complexity of the company.”

We appreciate your consideration of these comments. If you have any questions, please call me at 650-752-5339.

Cordially,

American Society of Corporate Secretaries

By: Marie Oh Huber
Chair, PCAOB Subcommittee
of the ASCS Securities Law Committee

cc: Alan Beller
Peggy Foran
Kathy Gibson
David Smith
Susan Wolf

D O N A L D   N E I L   A N D E R S O N

October 22, 2003

Office of the Secretary, PCAOB,
1666 K Street, N.W.,
Washington, D.C. 20006-2803.

Dear Sir,

PCAOB Rulemaking docket Matter No 008

I wish to comment on the new PCAOB draft standard referenced above. I write in the context on an informed private individual having spent my entire career in audit and finance both in Europe and the US. I am particularly motivated because of the loss of trust in financial markets and my own personal pension savings losses.

It is of great comfort to see that he PCAOB is establishing its independence of mind right from the start and is not minded to continue to allow the accounting profession to regulate itself. Indeed in the run-up to the issue of these standards I was following with interest the view of the profession that it would itself set the standards and more importantly it viewed the introduction of S 404 of Sarbanes Oxley as an opportunity to boost sagging profitability on audit work. As I understood it the profession viewed S 404 as a second government mandated franchise to extract much larger fees from its clients by calling the attestation on internal control over financial reporting a second audit engagement and therefore billable as such.

My view of the wording of Sarbanes Oxley is that the attestation of management's evaluation of the effectiveness of internal control over financial reporting is to be considered a necessary part of the audit of financial statements. It is work which enables the independent auditor to opine, in a truly meaningful manner, on the financial statements and is therefore a necessary component of the statutory audit. It should therefore be performed at no extra cost to the client's shareholders.

Indeed the implosion of Arthur Andersen has served only to redistribute the audit pie to an even smaller number of accounting firms. The fact that there are now only 4 firms left is in itself is not a desirable state of affairs, and I have disagreed with the mega mergers that have taken place on grounds of competition.

The audit profession came out of this far better than I or they could have expected, given their role and complicity, and in some cases outright involvement in the manufacture of schemes, which resulted in considerable losses to the shareholders and perhaps more important the stakeholders in the corporations involved.

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It is clear to me that public trust will only return to the markets in the same measure as the PCAOB and SEC visibly and boldly act to protect those markets. In the mid 1980s I spoke to Sir David Tweedie, then David Tweedie, who was just taking over at the IASB from Bryan Carlsberg. His view was that new standards would be ignored until standard setters were willing to publicly hang the first transgressor.

I can see that powerful lobbies have been visiting the PCAOB, and vested interests are being actively protected, notably the issues of additional client services performed by the independent auditor, independence and the issue of foreign jurisdiction. My hope is that the PCAOB will uphold the spirit of al of the provisions of the act. I would like to see non-US audit firms treat the inspections by the PCAOB very seriously indeed, and be aware that very competent people will be reviewing their activities and revealed failures can have dire consequences.

Before I answer the requested questions, I feel that there is one very important omission in the structure of the PCAOB draft standard. The standard often cites the pervasive nature of information systems and in fact notes that even the smallest of companies relies for its financial accounting and reporting on three level computer architectures, software, databases and infrastructures. Since the Treadway Report over 10 years ago the use of IT in financial reporting has expanded exponentially. My own experience tells ma that there are a bewildering number of applications, databases and infrastructures that combine together in layers to arrive at the consolidated numbers for a large international corporation. Even the analytical reviews and substantive tests will have recourse to some IT system output somewhere.

You mention that a standard or model for internal control could be the COSO or Treadway standard. No one would disagree. However I would like to see the Cobit standard added for internal control as applies to IT. It would in my view be a simple addition to the draft standard and would be fully understood by all auditors around the world. The standard points to the advantage of common standard and common vocabulary. The use of Cobit would I believe offer the same standard and reference point as regards IT systems and control. Recourse to Cobit would for example be very useful to resolve IT related control issues where management and audit differ in their view of significant deficiency or material weakness.

Yours sincerely,

Donald Neil Anderson.

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Responses to Docket Matter No 008

1. Yes. It is essential to have one unique definition or title. The wording adequately encompasses the "disclosure" controls envisaged in the Act.

2. No. If the opinion on the financial statements is independent of the S 404 opinion why should the auditor have to perform a financial statement audit? It makes sense of course but the S 404 attestation includes text that refers to possibility or probability as opposed to certainty such as, "more than a remote likelihood" It is possible is it not that internal control over financial reporting could be bad but the reported amounts present a true and fair view?

3. Yes. I view the work on internal control as a component of the work needed to attest to the assertions of management regarding the financial statements. Otherwise what is management basing their assertions on?

4. Yes. By implementing "principle-based" as opposed to "rule-based" standards the appropriate forms applicable to small and medium sized companies should be relatively clear in each circumstance.

5. Yes. It is clear to anyone who has performed an audit or who has been audited themselves that the requirement of the profession to make profit from the work and still cover the compensation of Partners Managers and Staff not to mention overheads, requires that junior staff be used to the maximum. Persons in the profession wish to progress as quickly as possible so there is considerable mobility. The result is that more and more work is done by junior persons who are wholly unfamiliar with the business of their clients.

   Having served in the profession I know this to be true and I know that supervision is not always consistent either. From the client perspective I detect enormous amounts of discontent at the level and competence of staff performing the audits. In Germany a famous saying is that KPMG actually stand for **K**inderen **P**rufen **M**eine **G**eschellscaft, translated "Children Audit My Company". The youth/competence trade off is clearly an issue. I know for a fact that when older more experienced people are auditing the response from management is far higher, as well as the level and depth of explanation. A more experienced person is far less easier to fool and far more tenacious. The huge profits of the profession might be reduced but the stakeholders would be better served if audits were performed by competent experienced persons.

6. Yes. I cannot see how it would be possible to refute an assertion by management at any level without having more than a solid grasp of the internal control environment.

7. Yes. If adequacy of documentation can be considered as a control deficiency then the PCAOB should assist management and audit alike to determine what those criteria are. Without such criteria conflicts of opinion can easily arise.

8. Yes. Inadequate documentation demonstrates a lack of will on the part of management to engage in the spirit of the Act. Documentation is testimony to commitment and professional execution. It is also auditable and reviewable by all parties and should take a position in the "Control Environment" as defined by COSO.

9. Yes. Walk-through is a standard procedure. Making it mandatory only formalizes it.

10. Yes. The walk-through is a key audit procedure. If the auditor has to rely on his own opinion then this part of the audit should not be delegated.

11. Yes. Every year, every relevant assertion for all significant accounts and disclosures. To do otherwise would introduce a very serious flaw in the audit and the related opinion.

12. This is another one of those questions that needs to be answered. If all things were simple, or auditors were all –knowing then the auditor would not need the knowledge, expertise or experience of others. The world alas is otherwise. The auditor should be advised to rely on the work on Internal Auditor where that function is properly staffed and constituted. That is to say it is independent, expert and experienced and shares the reporting structure enjoyed by independent auditors. That is to say with access and reporting to the Audit Committee, staffed by qualified individuals .The same may be true of outside experts in specialized areas. The cost of the audit should be as low as possible and avoid duplication or parallel checks.

13. Yes. Systemic controls. Specialized controls such as Health and Safety, Expert controls such as Tax or Legal.

14. No. The standard should be more explicit about the work of internal audit. It should ascribe criteria that define what constitutes an internal audit department whose work can and should be relied upon. See above. CFOs will expect to see a cost effective coverage not duplication and confusion.

15. Yes. Flexibility in this domain brings in professional judgment, which is fine.

16. Yes. The auditor should collect the principal evidence on which the opinion is based.

17. No. The definitions are problematic. Firstly they are negatively stated. I think there should be more straightforward and not couched in unusual terminology. After all this is the critical part of the process. Definitions should more appropriate to internal control reports. Most reports rate deficiencies as low medium or high, each with its own simple definition. One High need not be significant but if accompanied by 25 Mediums the whole risk profile changes. In any audit of internal control there are going to be lots of issues and items, so it make s sense to look at a cumulative view of all of the issues ranked y importance. If The PCAOB wished there are already a number of ranking criteria available. If these same criteria were used by all auditors independent as well as internal, a great deal would be achieved at no cost, and great benefit to Boards and shareholders alike.

18. Yes. Audit reports are tightly worded in any case.

19. Yes. Without some idea of severity there is no consequential idea of importance and hence relevance. See 17 above for ranking criteria.

20. Yes. I have participated in many audit meetings when the true impact of a control weakness has in fact been either missed or over-stated. It is essential to get it all out on the table.

21. No. I think the PCAOB can go further with what constitutes the High risk or material weakness. The more comfortable people become with the criteria the less likely will be the misclassification of any deficiency.

22. Yes. The PCAOB will however have to issue guidelines on exactly what is expected, so Audit Committees can fulfill their obligations and how auditors should go about their annual check of the fulfillment of these obligations. The same applies to smaller entities although few of these will find themselves "issuers" and caught by the Act.

23. Yes. It depends on the quality of the guidelines set by the PCAOB. I am positive Audit Committees would like to have authoritative guidance on this subject.

24. No. No purpose is served by withdrawing from the engagement other than to create confusion, and introduce the possibility of "shopping around" for opinion. If the Audit committee is not competent surely this is exactly what shareholders need to know and what trust in financial statements is all about. Who should/will pay for a withdrawal?

25. No. A <u>single</u> material weakness should <u>not</u> be enough. Internal control consists of many issues some interlock and amplify other compensate and dilute. There may be one single "crock of gold" as in WorldCom and Ahold but this is rare and overly simplistic. An internal control report will not have a single material weakness, unless it is couched in very generic terms. What is more likely is that there will be a number of issues and the skill is to see what they all mean when put together. It is the weight of the issues in the final control matrix which is important to determine if control is effective or not, not one single large item. Auditors will have to look at and opine on softer issues like competence, compensation and motivation, estimation techniques and possible value ranges, complex assertions such as hollow swaps.

26. No. I think you describe control just as it is. That way you can opine on changes in the level and quality of control and demonstrate continued improvement which is something of more value to shareholders and markets. The High Medium Low matrix referred to earlier can be part of a balanced scorecard approach.

27. Yes. Where opinions differ the shareholders have aright to the expert opinion they have paid for. If they disagree with management's assertion the job is only half done in my view and adds a) no value b) considerable confusion c) considerable ill feeling d) constructs nothing. What is key to this issue is that management and the auditors share the same conceptual and practical view of what constitutes an internal control deficiency for the purpose of the Act. Management must be aware of the laws they are breaking, or the rules to which they are not conforming. Otherwise it gets to a difference of opinion and subjective interpretation as opposed to matters of fact.

28. Yes. Everything is to be gained by being as specific as possible.

29. Yes. There are many of these.

30. Yes. The idea of quarterly certifications is OK for the CFO and CEO on the numbers but for internal control it is over-kill. The only time the quarterly certification should demand independent audit work is a) the first opinion b) the follow up to an adverse opinion or qualification. For the rest the previous annual report suffices unless something new and of consequence has arisen ad interim.

31. Yes. See 30 above. Getting audit involved each quarter will mean that staff never leaves the client. This happens today for big clients viz Enron but increasing the quarterly obligation will only exacerbate this.

From: [Redacted]
Sent: Tuesday, November 11, 2003 11:22 AM
To: Comments
Subject: Docket #008, Internal Controls

*** PLEASE REMOVE NAME FROM POSTING IN PUBLIC COMMENTS IF POSSIBLE ***

Dear Sirs:

As controller for a large public company who is principally responsible for our organizations assessment of internal controls, I read your proposed rules with great interest. Finally I could refer to a set of rules that truly represented the intent of the standard setting body for some guidance. Your rules provide tremendous clarity and also a significant amount of ambiguity. Although at times seemingly very clear, they leave many things open to interpretation.

Our company has an executive steering committee with representatives from our internal audit department, IT department, accounting department, and executive offices charged with overseeing our organizations response to the requirements of Section 404 of the Sarbanes-Oxley Act. Our external auditor is represented on this committee and has played a key role in establishing our agenda based on their interpretations of the pending rules. The committee meets periodically to define the requirements necessary for our company to become compliant.

Our external auditor has provided us with some rudimentary tools to help enable us to document our controls throughout our organization. They have indicated that we need to be able to document these controls to a standard that they would find “acceptable.” They have refused to publicly provide specific controls that they think may be important. They have not allowed us to review their internal documentation (process narratives) related to internal controls from prior audits. However, they have actively sought to participate in “assisting” our team in “assessing” and “documenting” our controls. They have been careful to say they cannot help us “design” controls but have shown us that the SEC’s own rules clearly state that they can and should assist us in “assessing, evaluating, and improving” our internal controls.

Several of our internal team members have expressed dismay at the level and quality of the work being performed by the staff and seniors whom the external auditors have sent to “assist” us. Our staff has noticed that these individuals have very limited business experience, they lack an appreciation of our rather complex information systems environment, and they continually appear to be engaged in an exercise of “cutting and pasting” comments from prior year work papers as they complete templates, forms, and checklists that were all part of their existing audit methodology.

Needless to say our team is frustrated with both the quality and value that our external auditors have brought to the table. The team has brought forth this issue to several members of our executive team – but unfortunately our executives (myself included) are very reluctant to take an approach that is not consistent with our external auditors requirements. We have been reminded, at the executive steering committee meetings, that it is “important” to provide sufficient and extensive documentation in order to meet the requirements (some might say “demands”) of our auditors.

Our organization is spending thousands of hours on this “documentation” initiative. We are going through literally hundreds of different business processes and painstakingly recording control points throughout our system. We are identifying controls that will satisfy the external auditors requirements (many of which they have covertly provided to us in generic templates and other “off the record” discussions).

Recently we completed review of one major business process, or “cycle”, and asked the auditors to review the quality and completeness of this one major cycle. The feedback we received was very favorable. They did suggest that we would have to continue to perform the same evaluation and documentation for several of our other business units and subsidiaries. Overall, they were “pleased” with the level of detail and completeness of our efforts. Remember, they were very involved in helping us define our approach and execute the approach.

We also asked some internal business unit controllers to review the same documentation. We asked them if the information was complete, accurate, and of a nature to sufficiently identify significant control points that might likely prevent our financial reporting from being substantially inaccurate. The internal feedback we received was dramatically different then the feedback we received from our auditors. Our business unit controllers pointed out several flaws in the documentation whereby our internal controls could easily be undermined. They pointed out that several of the “key controls” that our auditors had helped us identify were meaningless. Surprisingly their standards for quality and completeness are much higher then our external auditors.

Having had the opportunity to step back and critically evaluate the work that they feel is “acceptable” I have been troubled by one simple question. Would this evaluation have helped prevent another Enron or HealthSouth? The answer is a simple NO. This troubles me greatly because our company, like many other companies, is going to spend several million dollars complying with these requirements and quite frankly they provide little or no value to our organization. More importantly, these efforts do not address the needs they were intended to assist in addressing.

This has to be one of the single worst regulatory initiatives imposed on business. It does not address the problem it purports to fix. It does not protect investors. If anything it provides them with a false sense of security and misleads them. The fact is much of what we did the auditors should do as part of their normal audit procedures. How an auditor cannot evaluate internal controls, as part of a financial statement auditor is incomprehensible.

It seems to me that the root cause of many of the major corporate failures that led to this legislation is in fact simply an audit failure. Audit firms have not performed appropriate quality audits. Auditors have repeatedly compromised their integrity and independence in pursuit of maintaining a relationship with their clients that enabled them to sell other highly profitable services.

As a result of these transgressions we have witnessed a few firms abuse the process. The auditors became too predictable and too concerned with selling tax shelters and internal audit services and less concerned with the audits. They admittedly used the audit as a loss leader for other service offerings.

Rather then impose strict rules on companies that provide no meaningful or purgative value to investors, I would suggest that you focus on the following critical reforms:

1) Require auditors to provide quality audits. Your inspectors should

closely review their audits and the auditors should be required to implement stringent quality improvements in their audit methods. The problem is not ineffective controls – the problem is ineffective audits.

2) Require audit firms of public companies to divest themselves of their tax, internal audit, and other consulting like services. These services could easily be provided by a separate entity. Audit firms that provide no other service except for audits would likely provide higher quality audits. They would not encounter the obvious independence and conflicts that are customary in today's environment.

3) Consider imposing a much less intrusive requirement on corporate executives relative to internal controls. I would suggest that you work with industry (instead of the public accounting profession) to develop an appropriate standard that would be reasonable to implement and possibly much more meaningful then the current proposed approach.

4) Place less emphasis on the "documentation" requirements and more on the principles of what contributes to a sound internal control environment. Many companies already have a strong internal control function, typically in internal audit. Having the auditors lead this initiative is not a good idea. It places them in the position that they will have to audit their own work (documentation). As we have seen their quality and understanding of internal controls is woefully inadequate.

5) Finally, I would advocate that you consider not requiring the auditors to "attest" to the assessment provided by management. Relieving the auditors of this responsibility and instead focusing on requiring them to conduct quality audits with minimum standards much higher then theer current standards would be more meaningful. You could then possibly establish some minimum expectations for companies relative to point #4 above in terms of internal audit procedures.

Having started my career working for one of the largest public accounting firms still in existence, I am truly disappointed in what I perceive as a total lack of quality and professionalism. Although the firms tout their "focus on quality" this is more political rhetoric then material fact.

We have been subject to unfair and excessive increases in the cost of our audit fees. The fees have more then doubled. In addition to these fee increases the auditors have also imposed additional fees for services that they are now providing relative to assisting us in meeting the 404 requirements. These fees are substantial and as I have expressed above the quality of these services is dubious. We also seem to be threatened by statements such as: "if you don't engage us now, we won't have resources to help you later," "If we are not on your team and no engaged to help you may not pass your audit," and "switching auditors may point to the other firms that you have an internal control weakness," are but a few examples of statements our Audit partner and senior members of his team have made.

These statements and tactics not only frustrate me and our team… they insult our organization. But there is very little we can do. Our auditors have convinced our Board that they are "just helping solve the problem the government created." They continue to blame government and congress for this and at least our team thinks the blame belongs in the public accounting profession.

The salaries and partner distributions that these professionals are drawing make Dick Grasso look like a pauper. Sure they may not be making a $140mm each but they are consistently overpaid relative to the value they bring to our firm. Our average billing rates are approaching $180/hour. This translates into an average cost per full time equivalent (FTE) of over $360,000 annually. This is outrageous! Many of their staff are inexperienced. By comparison our average compensation (fully loaded with benefits) for fulltime employees is only $112,000/employee.

We are being held hostage by our external auditors and there isn't much we can do about it. I have asked for my name and contact information to remain confidential because of the obvious threat to my career and my company if I should publicly proclaim my fears and frustration with this deception of the public investor. These rules do more to undermine investor confidence and corporate performance then they proclaim.

Sincerely,

[Redacted] (PLEASE REMOVE NAME FROM PUBLIC FILING)
Corporate Controller

Office of the Secretary
November 11, 2004
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket No. 008 – Proposed Auditing Standard

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Dear Board Members:

I applaud your efforts in preparing PCAOB Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements and the public comments you have solicited. However, the proposed standard gives conflicting directives to the Public Accounting Firms. On the one hand, they are advised to rely on the work performed by others, namely the Internal Audit Department and Management. However, the firms are also instructed to perform extensive walkthroughs on their own to test and evaluate the design of the internal controls giving rise to even a separate opinion on internal controls. This will cost many companies from an internal resource perspective to document the entire internal control environment and from a pure dollars standpoint to pay for the sharp increases in audit fees for the public accounting firms to re-do management's work.

Secondly, I believe we have lost sight of what a system of internal controls is designed to accomplish. If the controls are tested and opined on early in the year, they should not have to be retested at the end of the year unless there has been a material change in the control environment. Our auditors, Ernst & Young, are asking the Internal Audit Department to retest all audits on financial statement accounts completed prior to June as a result of the Proposed Auditing Standard. This is a tremendous duplication of audit work. Again, if the system of internal controls is functioning without material change, then we should be able to rely on the controls at year end. If corporate America can't rely on its system of internal controls for more than six months, then we have much deeper issues to deal with overall.

Sincerely,

[Redacted]

Re: PCAOB rulemaking docket matter no. 008 – proposed auditing standard

The PCAOB should try to meet the worldwide expectations surrounding the SOA Corporate Governance reform and contribute to the closing of an extremely dangerous credibility gap, as it is in the position to do if an innovative and effective standard is eventually issued.

- The proposed standard is very disappointing. It retains much of what was submitted by the *"big four"* and expresses an old fashioned, "pre-CoSO", self-serving, accountant's way of looking at control.
- Moreover, there seems to be a regression –in the position expressed by the external auditors- to an old fashioned way of looking at control; the "*audit paradigm shift*" and "*continuous assurance"* concepts (1), which were presented in 1998 to the world in the Aicpa's study on Assurance, seem to be completely forgotten now. For an audit firm who knows well its client, the logic of *continuous assurance* implies that no additional work of any significance should be required in order to attest to the effectiveness of internal control
- Radical changes are needed because an unreasonable burden is about to be charged over all companies listed in the US, when compared with other countries, where advanced corporate governance arrangements are in place, such as Canada and the UK.
- There is very little understanding of CoSO in the proposed standard and little more than a formal homage is paid to it. The reference to CoSO would allow for a much more intelligent, useful, manageable, less costly and burdensome exercise: a higher level overview, which would focus on the right issues and controls.
- The Coso framework (and suggested approach to assessing and reporting on internal control) should be the reference also because it has been extremely successful:
  - It is reflected in the most authoritative, subsequent frameworks (Rutteman-Turnbull in the UK, Coco in Canada, Basel committee in 1998, and it is, finally, incorporated, in its integrity, in the new ERM-Coso, which was released in draft and it is expected to be finalised in February 2004)
  - It has been translated in several languages (French, Italian, Spanish and Portuguese, to my knowledge) and adopted, as an authoritative reference or even as a standard, in several countries
  - It has been used, since years, by best practice internal audit functions to assess and report on internal control (not only in the US).
- The PCAOB should go way beyond the very narrow horizon, which is mirrored, in the current proposed standard. To this purpose it should:
  - Account for the international dimension of the issue and seek ideas and advice in other countries, such as the UK, where a wider internal control assessment and reporting (covering not only financial reporting but compliance and operational effectiveness as well) is carried-out, since 1998, as prescribed by the Combined Code of LSE and specified by the Turnbull operational guidance. A similar high level guidance should be provided by your standard, in my opinion.
  - Consider carefully, and look for, other (than accountants) parties' points of view on the issue of assessing and reporting on internal control; first and foremost, the PCAOB should listen, very carefully, to what the affected oganizations have to say and try perceive how all this is being received from them. One of the strongest points of CoSO is that it represents a shared vision of internal control, which was developed with the participation of CEO's and management and is aimed at the integration of internal control within operations.
  - Read carefully the "Executive Summary", at least, of the actual CoSO framework document (not only documents, derived therefrom, which express the accountants' interpretation thereof).
  - Consider asking the advice of consultants who have gained a worldwide reputation as "internal control experts", because of their recognized ability to carry-out internal control assessments and to report on them. External auditors have very limited experience on this complex subject.
  - Consult with internal control assessors (2) who do believe that CoSO and other similar frameworks are, in reality, appropriate tools for assessing the effectiveness of the internal control process. Those people have actually used these frameworks and gained experience and knowledge thereof, in the process. They have done so not to comply with any rule but solely in order to assess (as advised to do by the Treadway commission, back in 1987, and by the CoSO report) the internal control of their organizations, to learn whether this process would provide (or deny, when ineffective) the reasonable assurance of achieving the reporting, compliance and operational objectives of their organization.

- The “entity level internal control framework”, represents the very heart of the Internal Control assessment, in accordance with Coso vision. It is the most difficult to assess and where the most significant, dangerous, pervasive and difficult to mend, weaknesses can be found.
- The real risks and the significant control weaknesses emerge when the entity-wide assessment is carried-out. Almost any control weakness at the process/activity level could, in fact, be identified and remedied, when you have a strong internal control framework in place, whereas the strongest activity/process level control would be, easily, voided (circumvented, overridden, by-passed, ridiculed even) within a weak internal control framework. This is fully confirmed by Enron and Worldcom.
- The current focus, within the organizations, is on the documentation of low-level controls for financial reporting. This is absolutely unwarranted on the basis of such consolidated *new* way of looking at internal control; it has nothing to do with the prevention of significant fraud; it has always been considered with sufficient attention within the traditional auditors’ approach to assessing audit risk and there are no additional words which could be spent to deal usefully with this subject. There is no reason to put any additional emphasis on this subject, especially since it is subtracting attention to the really critical subjects which are -—as per CoSO- the control environment.
- There is an almost “grotesque”, disproportion in the proposed standard. A lot of attention and detailed guidance is devoted to the easy and less critical assessment of the activity/process risk-control status. In the meanwhile, the assessors is almost left alone to come up with some sort of assessment -and with the task of putting together the related evidence- when extremely difficult and sensitive issues are raised.
- This seems to reflect distrust in the ability to gather persuasive evidence when dealing with entity level control. The use of an anonymous survey of personnel (3) has become a recognised, effective and rather common way of gathering adequate evidence when dealing with the soft, decisive component of control. This technique is well known to the external auditors who regularly use it when assessing the stakeholders’ relationship and dialogue within corporate social responsibility’s assignments. To prescribe (or, at least, encourage) using this effective, widely tested and relied upon technique would represent a significant innovation and an improvement of the auditors’ ability to assess the soft component of internal control.

An Internal Auditor

Suggested readings:

- (1) see, as an example Bell, Mars .. Auditing organizations through a strategic lens – kpmg 1997
- (2) Roth: Control model implementation: best practices - IIARF 1997
- (3) See, as an example, El Paso company internal control questionnaire: http://www.theiia.org/iia/abouttheiia/research/Woller-ControlAssessmentSurvey.pdf

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November 20, 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

Dear Board Members:

I commend the Public Company Accounting Oversight Board's for the research and effort that has been put into the proposed auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements,* and appreciate the opportunity to comment on the proposed standard. The proposed standard was issued pursuant to Section 404 of the Sarbanes-Oxley Act of 2002 (the "Act").

Our Firm provides representation in securities and corporate governance matters to private and public companies, including "issuers" under the Act. I have had informal discussions regarding the comments below with several issuers, including several large public companies that are not clients of our firm. In addition, I personally am a non-practicing CPA and have experience as an auditor and as a corporate controller, so I have some experience in internal control issues.

(On a personal note, I should mention that I attended Mr. McDonough's presentation last night at the Georgia Society of CPAs dinner; I enjoyed his remarks and appreciated his taking the time to visit us in Atlanta.)

We believe that shareholders are benefited most when there is a proper balance between the benefits of improvements in controls and disclosure on the one hand, and the costs of those improvements on the other. Also, it is important for the process to be efficient and avoid undue duplication of effort. While the PCAOB proposed standard does a good job of giving a framework for internal control, it does not strike the proper balance of costs versus benefits. In addition, we believe that the standard should be more principles-based in giving guidance rather than specific rules. The attached comments are directed toward achieving a better balance.

Sincerely,

ARNALL GOLDEN GREGORY LLP

Robert F. Dow

Robert F. Dow

RFD:dsd

1689757v2

PCAOB Comments

Questions regarding an integrated audit of the financial statements and internal control over financial reporting:

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?*

Response:

No, we don't think this terminology is appropriate for two reasons. First, it is not consistent with the terms used in Section 404 of the Act. Second, the term "audit" has come to have a very specific meaning in the accounting literature as it relates to the audit of financial statements. We think using this term for the review of internal controls will cause confusion, thereto, possibly misleading investors as to the level of assurance that can be given to the attestation of internal controls. A higher level of assurance inherently can be given as to financial statements which speak only as of a past date. Although companies will review the internal controls as of a past date, by the nature of the review you are trying to give assurance regarding a system and its capacity to prevent misstatements in the future. This will always engender a lower level of assurance no matter how much work is put into it.

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?*

Response:

Yes. An audit of the financial statements provides unique insight into the internal controls.

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?*

Response:

No. The review should be part of the audit engagement, as specified in the Act.

Questions regarding the costs and benefits of internal control:

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?*

Response:

In the portions of the standard that address documentation, there should be an acknowledgement that smaller companies may have different levels of controls with many different levels of documentation, and that this is acceptable provided that the auditor can be satisfied that the general controls and closer review by management sufficiently compensate for the lack of other formal controls. This is one of the areas where the costs and benefits should be given special consideration.

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.*

Response:

No, this should be left to the judgment of the auditor.

Questions regarding evaluation of management's assessment:

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?*

Response:

Yes, the auditor should obtain some level of direct evidence. However, the auditor should be permitted to rely on the work of others to provide a large portion of the evidence.

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

Response:

Yes.

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?*

Response:

It is appropriate to have the auditor evaluate the severity. There will likely be varying degrees of documentation among companies and it would be difficult to draw a simple bright line rule that articulates the appropriate level of documentation in all cases.

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?*

Response:

Walkthroughs are an effective way for the auditor to learn the client's system and evaluate it. However, it is not necessary for the auditor to repeat the walkthrough every year. Once the auditor has performed a walkthrough for a significant process, in subsequent years the auditor should be permitted to rely on a combination of prior years' walkthroughs, inquiry of management that indicates no material change, and the results of testing which are consistent with management representations.

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?*

Response:

The auditor needs to perform the initial walk-through himself or herself. However, the auditor should be allowed to use the work of others to assist in the walk-through, e.g., review flow charts prepared by internal audit. Also, as noted in No. 9 above, it may not be necessary for the auditor to perform the walk-through every year. The auditor should be allowed to rely on the work of others to decide it is not necessary to re-perform a walk-through in a subsequent year.

<u>Question regarding testing operating effectiveness</u>:

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?*

Response:

The auditor should obtain some evidence each year, but should be able to rely on prior years' work to reduce the amount of testing in the current year.

<u>Questions regarding using the work of management and others</u>:

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

Response:

The auditor should be permitted and <u>encouraged</u> to make careful use of the work of management and internal auditors, to make sure the process is more efficient. The key is for the auditor to make an initial assessment of the objectivity and competence of the personnel performing the work. The auditor then should make selective use of the results of re-testing and the auditor's own testing to validate the conclusions.

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

Response:

The Board should re-craft these categories in the form of guidance for the auditor to consider in deciding the extent to use the work of others, rather than making mandatory categories. This would represent a better principles-based approach, and would lead to a more efficient process.

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?*

Response:

No. Because of the proposed standard's emphasis on having the independent auditor himself or herself provide the principal source of evidence, the role of the internal auditor will be minimized. The independent auditor should be allowed to place a higher degree of reliance on internal auditor's work than is suggested by the current proposal.

However, we do agree with the general tone of the proposed standard, which suggests that the auditor can place a greater degree of reliance on the work of an objective and competent internal auditor than on other sources.

The IIA standards, while helpful, should not be the exclusive source of guidance. The auditor should be permitted to make his/her own assessment by re-testing the internal auditor's work and reviewing the internal auditor's reports to the audit committee.

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)?*

Response:

There should not be a specified level of work. This will vary from engagement to engagement based on the company's risk profile, and the competence and integrity of the company personnel performing the work for management.

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?*

Response:

No. See responses to Nos. 12, 13 and 15 above. The auditor should always obtain <u>some</u> independent work, but may in some circumstances use the work of management and internal audit as the majority of its evidence. This determination would turn on two major considerations: (1) an overall risk assessment of the company's control environment, and (2) an assessment of the objectivity and competence of the personnel performing the work.

<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?*

Response:

The definitions are difficult to apply because of the problems in determining "remote." This definition has been difficult to apply even under SFAS No. 5. In addition, there is no definition of "inconsequential" which becomes an important concept in the proposed standard. Remote and inconsequential create too low of a threshold when combined with the requirement that a single material weakness results in an adverse opinion. This combination will lead to heated debates about the remoteness of the likelihood of errors and will create the temptation to be inconsistent with the definitions of remote and inconsequential. This will make consistency unlikely (or "remote").

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?*

Response:

The examples are helpful. Please consider adding additional examples in the future.

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

Response:

Yes. This is one of the most important steps in this process by the auditor and also the area that requires the greatest level of professional judgment.

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?*

Response:

Yes, all deficiencies should be communicated to management in writing. This serves to better document the work performed and to put management on notice of the deficiencies. Management's response represents an important factor in evaluating the control environment.

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

Response:

See comments 22 and 23 below re: audit committees. Otherwise, the matters listed by the board appear 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?*

Response:

The auditor should evaluate the role of the audit committee as part of its overall assessment of the control environment. In most cases, the auditor should not give a pass/fail type grade on the committee. To ask the auditor to do so may do harm to the important relationship between the auditor and the committee. There may be some extreme cases, e.g., a committee that has no meetings at all, where the auditor may conclude that there is a totally ineffective committee.

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

Response:

See response to No. 22 above. The auditor should include the audit committee as part of its overall assessment of the control environment. To require the auditor to make a separate pass/fail assessment of the committee will put too much strain on the relationship. Also, because the committee hires the auditor and serves as the auditor's overseer it will be difficult for the auditor to give an objective and frank assessment on a stand-alone basis.

24. *If the auditor concludes that ineffective audit committee oversight is a material weakness, rather than require the auditor to issue an adverse opinion with regard to the effectiveness of the internal control over financial reporting, should the standard require the auditor to withdraw from the engagement?*

Response:

Definitely not. The auditor should remain engaged and report its findings. This will better serve the shareholders than forcing the auditor to withdraw. In most cases, an ineffective audit committee would not make it impossible to do an evaluation and a report on internal control, although it would likely lead to some qualification of that report.

<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?*

Response:

No. The auditor should be <u>permitted</u> to issue an "except for" qualified report in instances where there is an isolated material weakness and there have been no errors or irregularities in the financial statements. However, in most cases the auditor would issue an adverse opinion.

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

Response:

Yes. See No. 25 above.

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?*

Response:

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?*

Response:

The Board should give more guidance in this area, and change the tone or the rhetoric to move toward finding acceptable ways for the auditors to help management make the internal control environment more effective and the control assessment process more efficient. Everyone understands that the auditor cannot design the controls that he/she then has to evaluate, but that does not mean that the auditor cannot give guidance and educate management without impairing independence. Give more examples of acceptable ways for auditors to do this.

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

Response:

SEC rules already preclude the independent auditor from designing controls or acting as internal auditor. That is sufficient.

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?*

Response:

Yes. The auditor does not have a duty to report at quarter end, nor should one be added. However, the auditor should not continue the engagement if he/she is aware of misleading disclosures about controls.

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

Response:

Yes.

AIMR®

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24 November 2003

Judith Primus
Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Email: **comments@pcaobus.org**

File Reference: **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***

Dear Ms. Primus:

The Association for Investment Management and Research® (AIMR) is pleased to comment on the Public Company Accounting Oversight Board's (PCAOB) Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. With headquarters in Charlottesville, VA, and regional offices in Hong Kong and London, AIMR is a non-profit professional organization of 67,000 financial analysts, portfolio managers, and other investment professionals in 115 countries of which 55,800 are holders of the Chartered Financial Analyst® (CFA®) designation. AIMR's membership also includes 127 affiliated societies and chapters in 46 countries. AIMR is internationally renowned for its rigorous CFA curriculum and examination program. More than 102,000 candidates worldwide enrolled for the June 2003 CFA Examination.

General Comments

We commend the efforts of the Public Company Accounting Oversight Board (PCAOB) to strengthen the financial reporting system for companies that are publicly traded in the United States, increase the reliability and validity of financial reports, and provide greater oversight and transparency of both the attest function and the evaluation of systems of internal controls. Reliable financial information is the life blood of the financial markets. Participants in these markets must have complete, reliable, and transparent information in order to make appropriate financial decisions, including valuation and investment decisions, and to properly allocate capital.

In recent years, when it became apparent to investors and other users of financial statements that they might no longer be able to rely upon the reliability of companies' financial disclosures, their trust and confidence in the markets collapsed. The loss of investor confidence has harmed everyone who participates in the financial markets, including the issuers of securities themselves. Consequently, we support strongly the PCAOB's initiatives which we believe will contribute in a fundamental way to restoring the essential trust and confidence of investors and other users of financial statements.

In particular, we support the Board's proposal to:

1. Require auditors to evaluate management's process for determining whether its standards are effective; and

2. Require auditors to gather evidence through testing to determine whether the

    a. Controls are effective, and

    b. Management's assertion to that effect is fairly stated.

The critical core of any audit of financial statements is the evaluation of the effectiveness of the company's system of internal controls. If material failures occur in the internal control systems, as we have seen in a number of the recent corporate collapses, then the reporting system cannot be relied upon to produce reliable financial statements. It is not sufficient that auditors merely review internal control system documentation and management's assertions as to the effectiveness of the system. Attestation as to the effectiveness of the system requires direct tests to evaluate the:

- Control environment;

- Control and other business and operational risks;

- Control activities;

- Information and communication system; and

- Monitoring of the control and reporting systems.

Auditors must test each of the critical components of internal control systems, and provide sufficient independent and competent evidence to be able to provide an opinion that can be relied upon by investors and other users of the statements. In the absence of such tests and evidence, there is no basis for reliance on the system, or for auditors to formulate an opinion on the financial statements, or for users (whether they are internal or external to the company) to rely on system outputs. Consequently, the risk premium that investors and other providers of capital will demand if they are to provide their capital to issuers of such financial statements will place a great burden on the operations of companies. We believe that failure to ensure the reliability of these systems will ultimately be more costly for everyone.

We realize and expect that the costs of audits will likely increase with the increased audit activities and that these costs will ultimately be borne by shareholders. We would observe, however, as been widely reported, that the average cost of audits has been artificially low in the past because of the effective subsidization of audit fees by revenues generated from additional services auditors provided to their audit clients. Indeed, one of the chief objections raised by the audit profession to the prohibition under the Sarbanes-Oxley Act of 2002 of auditors' providing non-audit consulting services to their audit clients was that without those services, the audit firms would have to increase their audit fees significantly. Shareholders were already bearing the costs of *both* the audits and the additional consulting services.

There is a clear economic tradeoff between the cost of audits and the cost of capital. That is, if, in order to reduce or contain audit costs, the scope of audit activities is restricted, then the resulting decrease in the confidence that users have in audited financial reports will be reflected directly in higher costs of capital demanded by investors. Moreover, because of the greater uncertainty resulting from reduced reliability, we believe the increased risk premium is likely to be greater than the cost savings realized by the reduced audit activities. Such a circumstance would ill-serve issuers and their existing shareholders as well as other investors.

We also concur with the Board's proposal that auditors should identify circumstances that constitute a significant deficiency and which are a strong indicator of material weakness. In particular, the proposal states that the auditor should evaluate the effectiveness of the audit committee's oversight of the company's internal control and external financial reporting systems. A cornerstone of effective as well as efficient internal control systems is a strong and continuous internal monitoring and audit function.

The Sarbanes-Oxley Act mandated that US registrants must have an effective and independent audit subcommittee within their boards of directors. This committee would serve as the apex of the internal audit and financial reporting functions. However, it is not sufficient that such a committee be formed. Rather, in order to fulfill the intent of the Sarbanes-Oxley legislation, the effectiveness with which the committee performs its fiduciary responsibilities to oversee the internal control system and financial reporting process must be assessed as well. Again, in a number of the recent corporate collapses, it was clear that the directors failed in their responsibility to monitor and evaluate such systems, and, in some cases, had even acquiesced in management’s overriding of the control systems.

Consequently, we concur with the provision to expand the auditor's current responsibilities to evaluate the effectiveness of the oversight function, particularly with regard to the audit committee's responsibilities. We do not believe that this will involve a significant increase in the costs of audits because auditors are currently required to communicate with the audit committee and discuss with them both the results of their audits and any concerns or material deficiencies revealed by their tests. Indeed, this increased responsibility could lead to greater cooperation between auditors and the committee. We believe that improving this relationship could make a very constructive contribution to both the auditor's work and the audit committee's efforts and effectiveness.

Concluding Remarks

In conclusion we support the Board's efforts to improve the quality and effectiveness of audits of companies that are publicly traded in the United States and believe these proposals will lead to greater reliability and transparency of the financial reports that are essential to investors and other participants in the financial markets. We strongly encourage the Board to continue with such improvements.

AIMR appreciates the opportunity to express its views on the Proposed Auditing Standard, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*. If the Board or staff have questions or seek amplification of our views, please contact Rebecca McEnally at 1-434-951-5319 or at rebecca.mcenally@aimr.org. We would be pleased to answer any questions or provide additional information you might request.

Respectfully yours,

/s/ Patricia Doran Walters

Patricia Doran Walters, Ph.D., CFA
Senior Vice President, Professional Standards
And Advocacy

/s/ Rebecca Todd McEnally

Rebecca McEnally, Ph.D., CFA
Vice-President, Advocacy, AIMR

cc: Advocacy Distribution List

THE ASSOCIATION OF THE BAR
OF THE CITY OF NEW YORK
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FINANCIAL REPORTING COMMITTEE

November 21, 2003

Via email: comments@pcaobus.org
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Attention: Office of the Secretary

Re: PCAOB Release No. 2003-17; 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

Ladies and Gentlemen:

This letter is submitted on behalf of the Financial Reporting Committee of The Association of the Bar of the City of New York (the "Committee") in response to Release No. 2003-17, October 7, 2003 (the "Release"), in which the Public Company Accounting Oversight Board (the "PCAOB") announced a proposed auditing standard for Internal Control Over Financial Reporting (the "proposed standard" or "proposal"). Our Committee is composed of lawyers with diverse perspectives on securities issues, including members of law firms, counsel to major corporations, investment banks, and institutional investors.

Introduction

The Committee supports the PCAOB's objective of creating an integrated standard for the purpose of performing an audit of internal control over financial reporting in conjunction with an audit of the financial statements. The recommendations that follow are offered with the intention of revising definitions which could lead to unintended outcomes with costs to companies and shareholders that far exceed the benefits to investors and to make suggestions that further support the goal of an efficient, effective, and integrated audit through principles-based rulemaking as opposed to overly rigid, technical rules. While our responses refer to specific question numbers, we have organized our responses not by the sequential numbering of the PCAOB's questions, but rather by the importance we believe each topic deserves.

1. Overview.

We request that the PCAOB consider four main themes:

- Certain of the key definitions have thresholds that are too low.
- Certain of the rules, particularly those related to the identification of fraud, should be more principles-based and less rigid to allow external auditors to assess the facts and circumstances of each individual situation and to exercise their professional judgment in light of these facts and circumstances.
- Certain of the required activities of auditors are inappropriate, beyond their expertise and impose inherent conflicts of interest that will impede the relationship between the audit committee and the auditor and undermine the enhanced authority of the audit committee granted by Sarbanes-Oxley.
- Auditors should be given greater ability to rely on internal audits where, in their professional judgment, such reliance is appropriate.

A. Certain Definitions Should Have Higher Thresholds.

Although the PCAOB may not be able to perform a cost impact analysis as to the new requirements to be implemented in the proposed standard, we believe the PCAOB should consider the impact of definitions that we believe include excessively low thresholds by which to measure deficiencies. A complete discussion of our proposed revisions to the thresholds definitions is included below. We request that the PCAOB keep in mind while reviewing our comments that the proposed requirements will be broadly applied and will not be limited to issuers and auditors with unlimited resources.

B. Rules, Particularly Those Related to the Identification of Fraud, Should Be Less Prescriptive and Rigid and More Principles-Based to Allow External Auditors to Exercise Professional Judgment.

We believe the general preference of the Securities and Exchange Commission ("SEC") for principles-based accounting over rules-based accounting should extend to some of the new PCAOB proposals identified below. In our opinion, certain proposed standards are too prescriptive and rigid and we respectfully suggest that those technical, rigid rules be replaced with more principles-based rules under which certain facts and circumstances would be identified as factors to be considered by the external auditor rather than as items mandating certain findings. The proposal states repeatedly that external auditors must be able to exercise judgment so that their procedures adapt to the size and complexity of each public company. We respectfully submit, however, that the proposal in certain areas does not adequately allow exercise of that professional judgment because in many instances the rules are too mechanical in that they mandate certain findings and are more "check-the-box" in approach rather than allowing the external auditor to give appropriate consideration and weight to the items specified in the proposed rules.

For example, the proposal specifies a rigid list of circumstances in which an external auditor must find at least a significant deficiency and provides that an auditor should consider those circumstances as a strong indicator of a material weakness. We believe such a rigid list would detract from the ability of external auditors to exercise their professional judgment in a meaningful manner.

We believe mandating annual walkthroughs of **all** of the company's significant processes for **all** types of transactions and events, both recurring and unusual, is excessively prescriptive. Also, the extent to which external auditors must review management's documentation should be determined in part by the external auditors using the PCAOB's principles on how to make that determination, not by rigid rules that dictate the degree of review required.

The SEC Fortune 500 review resulted in a substantial number of financial restatements by corporations to reflect the current SEC policy on identification and aggregation of segments. Applying the proposal, the external auditor may be required to automatically label a company as having a significant deficiency or material weakness in financial reporting even though the segment reporting was not intentionally misleading or fraudulent, but instead improperly aggregated in light of guidance released after the publication of the financial statements in question. We believe such a result would be inappropriate and perhaps even unfair. External auditors should be guided by the principle that the factors surrounding the need for a restatement should be considered in determining whether a significant deficiency or material weakness exists. There should not be an arbitrary rule that all restatements must fall into one of those categories without having the external auditors exercise their professional judgment in considering the circumstances surrounding the restatement. A restatement reflects an issue in a prior reporting period; it should not automatically result in a significant deficiency or material weakness in subsequent periods.

Similarly, we respectfully submit that the identification of fraud *of any magnitude* as an automatic significant deficiency and a strong indicator of a material weakness is too rigid and arbitrary. The magnitude of the fraud, the length of time over which the fraud was committed and the method of its discovery are all factors that should be considered by external auditors in determining whether a significant deficiency exists. If fraud is detected through existing internal control procedures and it is determined that the fraud in question was isolated, not material to the company and was not committed over a lengthy period of time, that may in fact evidence proper internal controls. As stated in the proposed standard, there are both preventive and detective controls, and the discovery of fraud is an accomplishment of the detective control system. Accordingly, we submit that the external auditors should be able to consider discovery of the fraud by the internal control system as a mitigating factor.

In our opinion, the appropriate principle should be that circumstances surrounding a finding of fraud should be examined by external auditors and they should use their professional judgment about the circumstances surrounding and the seriousness of each fraud. Using that judgment, the external auditors will likely determine that a fraudulent act committed by a senior member of a multinational retail chain's internal accounting staff indicates a greater likelihood of a serious problem than a single double billing fraudulent act related to an airline ticket reimbursement committed by a senior marketing manager. The latter does not indicate a significant deficiency and possibly a material weakness, whereas the former may very well so indicate.

Proposed Rule: Paragraph 126 -- "Each of the following circumstances should be regarded as at least a significant deficiency and is a strong indicator that a material weakness in internal control over financial reporting exists," and continues to list said circumstances.

Suggested Revised Rule: "In each of the following circumstances, *the external auditor should conduct appropriate inquiries and procedures to determine whether a significant deficiency, and possibly a material weakness, exists*."

2. Definitions.

Questions 17-18: 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? 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?

Considering that the proposal revolves around identifying significant deficiencies and ultimately material weaknesses in the internal control of financial reporting, we feel most strongly about implementing definitions with realistic thresholds that are principles-based and act as proper filters for identifying internal deficiencies.

First, both terms center on the standard of "remote likelihood," and refer to the definition of "remote" in SFAS No. 5. SFAS No. 5 defines "remote" as the "chance of the future event or events occurring is slight." It is our belief that such a threshold is far too low, and not only differs from the "reasonable assurance" standard required by management that was adopted by the SEC in Release No. 33-8238 and reflected under COSO and Codification of Statement on Auditing Standards AU §319.18, but would also make for a condition in which every auditor would be forced to create a laundry list of deficiencies, no matter how small or insignificant.

This lies in stark contrast to the AICPA standard of a "reportable condition," which allows the auditor to use professional judgment in determining whether a significant deficiency exists. Under the current state of the proposal, the PCAOB would essentially be tying the AICPA auditing standards to the lowest threshold of probability for a material misstatement under SFAS No. 5. Creating such a definition for "significant deficiency" would have consequences that lower the bar across all auditing procedures.

The possibility of human error or inadvertent misjudgment at every level of preventive or detective control would make it difficult, and nearly impossible, to categorize even the most stringent internal control system as reducing possibility to "slight." We believe that even in corporations with the most effective internal oversight, the chances of a material misstatement can be reduced only to "probably not," a definition that follows most closely the "reasonably possible" standard of SFAS No. 5, which is defined to mean "the chance that a future event or events occurring is more than remote but less than likely." Even at this level, however, we believe that many of the significant deficiencies identified will not be material, but nevertheless may cause auditors to issue unwarranted adverse opinions or refuse to issue an opinion at all. Investor confidence will not be restored in financial reporting of public companies if well-managed companies with robust internal controls are not able to meet unnecessarily strict and inadequately differentiated standards.

Probable	The future event or events are likely to occur.
Reasonably possible	The chance of the future event or events occurring is more than remote but less than likely.
Remote	The chance of the future event or events occurring is slight.

The term "inconsequential" in the definition of significant deficiency is not defined and confuses the definition of the threshold at which auditors must declare that such a problem exists.

<u>Proposed Rule:</u>

- <u>Paragraph </u>8 -- A *significant deficiency* is 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. 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.

- Paragraph 9 -- A *material weakness* is 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.

Suggested Revised Rule:

- "Significant deficiency" *is a single deficiency, or a combination of deficiencies in the same or closely related reporting area, that results in a reasonable possibility that a misstatement of the annual or interim financial statements* in an amount that is *more than de minimis but less than material will not be prevented or detected*." **OR** the term as currently used by the AICPA.

- "Material weakness" *is a significant deficiency that, by itself, or in combination with other significant deficiencies in the same or a closely related reporting area, results in a reasonable possibility that a material misstatement of the annual or interim financial statements will not be prevented or detected*."

These revised definitions have higher thresholds using terms with which accountants already have experience and extensive accounting literature and guidance. We believe the higher thresholds are more likely to provide practical warning flags rather than extensive laundry lists of false negatives.

3. <u>External Auditors Should Be Able to Use the Work of Others At the External Auditors' Discretion.</u>

Question 12-15: To what extent should the auditor be permitted or required to use the work of management and others? Are the three categories of controls and the extent to which the auditor may rely on the work of others appropriately defined? 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? 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)?

The proposal specifies certain procedures that must be performed by the auditor such as mandatory requirements for the external auditor to retest internal controls over other controls as well as those over fraud. We believe this rule should be rewritten to allow the auditors to exercise discretion on the extent of review required and the frequency with which these reviews must occur (for example, if a review was done in a prior year, we do not believe it necessarily, under all circumstances and for all issuers, needs to be completely redone in subsequent years). We believe the PCAOB should also recognize that unnecessary retesting by auditors can result in interruption of the operations and financial reporting processes of companies.

In being so prescriptive, the PCAOB proposal risks undermining the role of an internal audit entirely, or, in the case of a smaller company, creating a financially unsupportable situation for the simultaneous presence of both internal and external oversight structures. The rules should make clear that the auditors should be free to exercise their reasonable professional judgment on the appropriate reliance level on internal work, including the work of internal auditors.

If the testing of the controls listed in Paragraph 104 of the proposal becomes mandatory for an outside auditor, management's incentives could shift from ensuring that their own internal auditors properly test the design and operation of these controls, at a high cost, to limiting the internal audit function involvement in such testing, thereby encouraging companies to cut costs in areas which will be retested by external auditors rather than paying twice for the same services. This will have the effect of undermining the role of the internal auditors.

We believe the three-tiered categorization of where to retest certain internal controls is too rigid and precludes auditors from exercising professional judgment. Why is it more important for an outside auditor to retest internal controls designed to prevent fraud on nonroutine transaction errors instead of testing those controls over routine transactions? We do not believe in a blanket rule that implies the existence of a hierarchy between transactions within a system of internal controls. The professional judgment of auditors should not be hindered or superceded in this rigid manner.

Proposed Rule:

- Paragraph 104 -- "There are a number of areas in which the auditor should not use the results of testing performed by management and others, including: (list of certain tests)"

- Paragraph 105 -- "The auditor's use of the results of procedures performed by management and others should be limited in the following areas: (list of certain tests)"

- Paragraph 106 -- "The auditor might decide to use the results of tests performed by management and others within the company in other areas, such as controls over routine processing of significant accounts and disclosures, without specific limitations."

Suggested Revised Rule: We respectfully submit that Paragraphs 104-106 be omitted and that the PCAOB rely solely on Paragraph 103 as proposed:

"The auditor should evaluate whether to rely on the work performed by management and others. When evaluating whether to use the results of procedures performed by others, the auditor should evaluate the following factors:

- The materiality or the risk of misstatement of the accounts and disclosures that the controls address.
- The degree of judgment required to evaluate the operating effectiveness of the control.
- The degree the control can be subjected to objective testing vs. a subjective evaluation.
- The pervasiveness of the control.
- The level of judgment or estimation that is required in the account or disclosure."

4. Evaluating Audit Committee Oversight Should be Significantly Reduced and the Proposal Requiring the Auditors to Evaluate Audit Committees Should be Dropped.

Questions 22-23: 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? Will auditors be able to effectively carry out their responsibility to evaluate the effectiveness of the audit committee's oversight?

Audit committees retain, supervise, compensate and fire auditors, as directed by Sarbanes-Oxley and the rules of securities exchanges and self-regulatory organizations. We respectfully believe, therefore, that the auditors should not be required to test the "effectiveness" of the audit committee. Effectiveness is not defined - does it mean failure to recognize issues, ability to recognize issues but failure to adequately address them, or something entirely different?

The proposal would require the auditor to evaluate the effectiveness of the audit committee's oversight of external financial reporting and internal control. Included in this evaluation are factors such as independence from management, clarity of the committee's responsibilities, level of involvement and interaction with the auditor and internal audit, including the committee's role in appointment and compensation of the auditor and internal audit, presence of an audit committee financial expert, compliance with applicable listing standards, the amount of time the committee devotes to control issues, and the amount of time committee members are able to devote to committee activities. This would require a much greater degree of involvement by the auditors in the internal operation of the audit committee and require observation of the work of the audit committee and the individual members as well as their interaction with third parties, such as internal audit. This would require skills that are beyond the expertise of auditors (such as knowledge of listing standards and interpretations). It would also interfere with the allocation of responsibility to the audit committee by state corporation law and by Sarbanes-Oxley.

In particular, the proposed standard requires the auditor to determine independence in the selection of candidates for the audit committee. This raises many issues of whether an auditor is qualified and able to make the subjective and perhaps legal determinations required by the proposal. It also presents conflicts since the auditors are to report to and be compensated by the audit committee. Can they be realistically requested to objectively make the enumerated determinations? Or does this present such a fundamental conflict of interest that it should not be required? We believe auditors currently view the audit committee as an important part of the financial integrity of a company and its internal control, but the key consideration for them is whether they have adequate access to and reaction from the audit committee rather than whether the audit committee is acting as a monitor.

Proposed Rule: Paragraph 58 -- "As part of evaluating the independence of committee members, the auditor should evaluate how audit committee members are nominated and selected and whether they act independently from management. Generally, the more independence that is built into the process of nominating members of the audit committee to the board, the more the auditor can be assured of committee independence. For example, are qualified candidates identified by outsiders, such as an outside search firm or a nominating committee composed of outside directors, or does management pick 'friends?' Are board candidates for the audit committee selected based upon desired skill sets?"

Suggested Revised Rule: Delete the requirement.

In addition, auditors should not be in a position of undermining the current requirement that boards determine the qualifications of the audit committee Financial Expert ("ACFE"). Sarbanes-Oxley made this decision the responsibility of the Board of Directors; the PCAOB should not change that responsibility. The standards for determining an ACFE are prescribed by the SEC pursuant to statutory direction, as implemented by the SEC's rule, and the Board's determination of satisfying that standard, which is likely a legal interpretation, should not be challenged by the auditor if the Board has based its decision on the SEC's implementing regulation. Sarbanes-Oxley also made the audit committee financial expert not a requirement, but a disclosure item. The Board of a reporting company could conclude that finding a person meeting the rather restrictive qualifications of the SEC's rule was unnecessary because it has confidence in the expertise of the members of its audit committee. The PCAOB would change this dynamic with its proposal.

5. Qualified Opinions Should be Allowed.

Questions 25-26: 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? Are there circumstances where a qualified "except for" conclusion would be appropriate?

Under the proposal, if there are one or more material weaknesses, management would be precluded from concluding that internal control over financial reporting is effective. In these circumstances, the auditor is required to express an adverse opinion on the company's internal control over financial reporting in connection with the annual attestation report and would not be permitted to issue a qualified "except for" opinion. For the reasons specified below, we respectfully submit that qualified "except for" opinions might be appropriate under certain circumstances.

We believe that during any given year, a significant number of public companies have outstanding "material weakness" designations, and we believe that it almost invariably takes more than one quarter to rectify them. Because it is in everyone's interest, particularly investors', to have problems identified and remedied, detecting a material weakness should not so significantly penalize a company that no opinion can be issued, resulting in consequences far beyond the magnitude of the material weakness, such as limiting the company's access to the capital markets. This result would have an enormous chilling effect on identifying problems in the first place and on capital markets transactions.

Proposed Rule: Paragraph 162 -- "If there are significant deficiencies that, individually or in combination, result in one or more material weaknesses, management is precluded from concluding that internal control over financial reporting is effective. In these circumstances, the auditor must express an adverse opinion on the company's internal control over financial reporting."

Suggested Revised Rule: Paragraph 162 -- "If there are significant deficiencies that, individually or in combination, result in one or more material weaknesses, management *must consider the extent of one or more material weaknesses in* concluding that internal control over financial reporting is effective, *and must disclose the nature of the material weaknesses and the actions being taken to correct them, in all earnings releases and 1934 Act filings*. In these circumstances, the auditors *should exercise professional judgment in deciding whether the nature of the material weakness requires them to issue* an adverse opinion on the company's internal control over financial reporting."

We respectfully propose that the PCAOB alter the requirement to allow for judgment on the part of auditors in identifying material weaknesses and determining whether the material weaknesses are being corrected as quickly as possible before issuing an adverse opinion.

6. Small and Medium-Sized Issuers

Question 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?

We applaud the PCAOB for not having prescribed a single method for compliance by all types of companies. Particularly, we agree with the PCAOB's view that "the nature and extent of controls that are necessary depend, to a great extent, on the size and complexity of the company." We respectfully urge the PCAOB to extend this acceptance of subjective decision-making by the auditors to the overall proposal as we have outlined in this letter.

7. Effective Date Question and Degree of Quarterly Auditor Involvement

The proposed standard would require the auditor to make inquiries of management on a quarterly basis about significant changes in the design or operation of internal control over financial reporting as it relates to the preparation of annual as well as interim financial information and to assess whether significant changes in internal control over financial reporting may have resulted in significant deficiencies or material weaknesses. Depending upon management's response, the auditor would be required to take additional action, ranging from communicating with the audit committee to reach an appropriate resolution to considering resigning from the engagement. Any communications of significant deficiencies or material weaknesses by the auditor may have an impact on and will need to be considered by management in making its Section 302 certifications and the company's disclosures under Item 308 of Regulation S-K. The effective date of the proposal, however, looks only to the 404 audit. We believe that the effective date of the proposal should be clarified to indicate that the 302 certification process with respect to matters covered in the proposal will not become effective until the respective 404 effective date.

The proposed standard would require an auditor to make certain determinations, "through a combination of observation and inquiry" as to whether significant changes in internal control over financial reporting have occurred during the quarter. We request the PCAOB to clarify that these determinations can be accomplished in connection with the current usual level of quarterly auditor involvement and will not require continuous observation by the auditor during the quarter.

Conclusion

We commend the PCAOB for proposing new standards of audits for internal controls over financial reporting. It is the belief of the Committee that the public would be well served if the PCAOB gave additional consideration to specific elements of the proposed rule, as set forth in this letter.

Please note that Committee member Wayne Carlin of the United States Securities and Exchange Commission did not participate in the preparation of this letter or the vote by the Committee to submit this letter to the PCAOB. In addition, this letter does not necessarily reflect the individual views of members of the Committee.

Members of the Committee would be pleased to answer any questions you might have regarding our comments, and to meet with the Staff if that would assist the PCAOB's efforts.

Respectfully Submitted,

/s/ N. Adele Hogan
N. Adele Hogan, Chair of Committee on Financial Reporting

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*The drafting subcommittee gratefully acknowledges the assistance of Eliot Bencuya in the preparation of this letter.

Consultation Response

PROPOSED AUDITING STANDARD

AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS

PCAOB Rulemaking Docket Matter No. 008

Comments from ACCA

November 2003

ACCA is the largest and fastest-growing international accountancy body. Over 300,000 students and members in 160 countries are served by more than 70 staffed offices and other centres.

ACCA's mission is to work in the public interest to provide quality professional opportunities to people of ability and application, to promote the highest ethical and governance standards and to be a leader in the development of the accountancy profession.

Further information on ACCA is available on ACCA's website, www.accaglobal.com

General Comments

ACCA is please to provide comments on 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* (the Proposed Standard).

PCAOB is currently issuing new standards while having established Interim Professional Auditing Standards in respect of auditing, attestation, quality control, ethics, and independence. These Interim Professional Auditing Standards are essentially those that were established by the American Institute of Certified Public Accountants (AICPA). ACCA considers that, to further its objectives over the longer term, it is vital that PCAOB develops new standards that promote consistent, high quality auditing around the world. To achieve this, we strongly encourage PCAOB to ensure that, wherever possible, it develops standards that are consistent with those of the International Auditing and Assurance Standards Board of the International Federation of Accountants. Global harmonisation of auditing standards of the highest quality is essential to the integrity and efficiency of capital markets and we encourage PCAOB to work closely with IAASB to achieve that end.

Our primary concern with the Proposed Standard is that its emphasis on requiring auditors to obtain direct evidence of the effectiveness of internal control, taken together with the extent of detailed requirements and guidance, may cause auditors to adopt a 'bottom up' rather than a 'top down' approach to their work. The 'bottom up' approach is neither effective nor efficient.

Corporate failures, such as Enron and WorldCom can be attributed to weaknesses in the control environment. The risk is that a 'bottom up' approach may mean that auditors pay insufficient attention to the control environment, which COSO rightly recognises as *'the foundation for all other components of internal control'.*

Companies already face cost increases relating to their own compliance with the Act. There is a risk that they will also experience both direct and indirect costs of auditor inefficiency that are greatly disproportionate to the benefit to their investors.

ACCA has a wide experience of auditing in many jurisdictions and we are aware of the fact that many will heed the words in the Proposed Standard that: *'the Board expects that the auditor will exercise reasonable professional judgment in determining the extent of the audit of internal control and perform only those tests that are necessary to ascertain the effectiveness of the company's internal control.'* Nevertheless, we perceive a significant risk that, particularly for larger enterprises, auditors will do too much work. If this happens, there is a risk that PCAOB standards themselves will be devalued. We urge PCAOB to address this perception problem aggressively to ensure that standards are seen as proportionate and cost effective as well as being of the highest quality.

Response to the Questions in the PCAOB's Request for Comments

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?

No. It would be better to retain the term 'audit' for the financial statement audit and to refer to the attestation as an attestation.

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?

Yes. The Act does not anticipate that these engagements will be separate.

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?

We see no value in requiring equivalent work without actually reporting as the financial statement auditor.

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. Much of the guidance is, however, given in Appendix E rather than in the main body of the Proposed Standard.

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.**

Yes - generally. This is an area where the PCAOB should consider harmonisation with the IFAC standards on education and quality control.

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. It is important that the auditor does not simply rely on others throughout. In our general comments we have, however, drawn attention to the risk of auditors doing too much work because they perceive that obtaining direct evidence is emphasised.

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

Yes. Criteria are necessary and the provision of consistent criteria beneficial. We suggest, however, that the criteria in paragraphs 43 to 47 may be perceived as inflexible and that auditors might concentrate too much on documentation.

8 (a) Is it appropriate to state that inadequate documentation is an internal control deficiency, the severity of which the auditor should evaluate? (b) Or should inadequate documentation automatically rise to the level of significant deficiency or material weakness in internal control?

(a) Yes. This allows for the use of professional judgement.
(b) No.

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

No. Walkthroughs may be useful in some systems but provide little evidence of effectiveness. The 'controls' identified by walkthroughs are often no more than aspects of the accounting system which provide little mitigation of business risks.

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?

No. The auditor should use professional judgement to determine the extent to which he or she performs walkthroughs.

11 (a) 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 (b) every year or (c) may the auditor use some of the audit evidence obtained in previous years to support his or her current opinion on management's assessment?

(a) Yes. We are concerned however that this will be perceived as requiring all low level controls to be tested.
(b) & (c) Although audit evidence may be obtained from work carried out in previous periods, the migration of that evidence to the current period is a complex matter of audit methodology which is rightly left to the judgement of the auditor.

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

This should be permitted as a matter for the judgement of the auditor.

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

No. We suggest that such material would be better presented as guidance and the decisions on reliance on the work of others left to the auditor.

14 Does the proposed standard give appropriate recognition to the work of the internal auditors? If not, does the proposed standard place too much emphasis and preference on the work of internal auditors or not enough?

Yes. Internal auditors play a vital role in many companies and it is appropriate that the independent auditor has the capacity to rely on their work.

15 (a) Is the flexibility in determining the extent of reperformance of the work of others appropriate, or (b) 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)?

(a) Yes.
(b) No. This should be a matter of professional judgement.

16 Is the requirement for the auditor to obtain the principal 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?

No. This should be a matter of professional judgement. A requirement in this regard would add substantially to the perception that the Proposed Standard is not cost effective.

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?

Yes. Auditors need to focus on matters of significance and materiality. The definitions are one area where PCAOB should avoid issuing a Standard that is not easily reconcilable to the output of IAASB.

18 (a) Do the examples in Appendix D of how to apply these definitions in various scenarios provide helpful guidance? (b) Are there other specific examples that commenters could suggest that would provide further interpretive help?

(a) Yes.
(b) We do not suggest any further examples.

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

Yes. The evaluation need not be extensive except where there is a potentially significant deficiency.

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. Trivial matters should, however, be excluded from such a requirement.

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

Yes.

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?

This is a difficult question. Theoretically the auditor's relationship with the audit committee may preclude such an evaluation. Nevertheless, oversight exercised by the audit committee may in itself be important to internal control. On balance we suggest that there be no requirement to evaluate the effectiveness of oversight as a separate matter but that the impact of the work of the audit committee can be a factor that the auditor considers as part of his or her evaluation of the internal control environment at the highest levels.

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

See our answer above.

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?

See our answer above.

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?

No. The auditor should use professional judgement to determine whether an adverse conclusion is appropriate (see answer below).

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

Yes. In some circumstances, such an opinion will provide better information to users and this should, therefore, be a matter of professional judgement.

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 internal control over financial reporting rather than to whether management's assessment is fairly stated?

No. The Act is concerned with management's assessment. PCAOB should consider research of user understanding before moving towards a direct report.

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

No. Independence should be addressed in other pronouncements.

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

It would be appropriate to refer to the SEC independence rules.

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. In the case where a rule requires quarterly certifications of a different nature to annual certifications it is appropriate for the responsibility of the auditor also to differ.

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

Yes. Given the limited nature of quarterly certification we do not believe that more should be required.

TECH-CDR-349

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November 20, 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

Ladies and Gentlemen:

The financial management of AT&T Corp. ("AT&T") would like to thank the Board for the opportunity to comment on your proposed auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("the proposed standard"). AT&T would like to commend the Public Company Accounting Oversight Board (the "Board") for their work in preparing this proposed standard. AT&T supports the requirement for management to take responsibility for creating and maintaining an effective control environment. We believe this is an important cornerstone for reliable financial reporting.

For the most part, we believe that the proposed standard represents a good approach to achieving the objectives of Section 404 of the Sarbanes-Oxley Act of 2002. However, AT&T does see a few areas where some cost/benefit improvements can be made. Specifically, we believe that the external auditors should have the ability to rely more heavily on the work of independent, internal audit departments that they have assessed to have the skills necessary to properly evaluate internal controls. This is especially true in the information technology controls area. We also believe that after the base year audit, where the external auditor has done all the required independent testing of management's internal control assertions, that some sort of rotational, independent work could be done with more reliance placed on management's work. However, if paragraph 101 of the proposed standard provides for this flexibility then the only comment we have relates to the ability of the external auditor to rely more heavily on the work of the internal auditors.

Using the Work of Management and Others

In general, AT&T agrees with the three categories that the Board has included in the proposed standard, however we believe that types of controls included in the section where the external auditor cannot place any reliance on competent, independent internal audit testing could be overly restrictive. Specifically, we believe that the Board has placed little value on the documentation and testing performed by internal audit for internal controls that have a pervasive effect on the financial statements, in particular general information technology controls. The proposed standard requires that the external auditor complete its own series of tests for which similar, if not identical testing plans and results are available from internal audit. At many companies these control activities are mature and the external auditor can re-perform testing of general information technology controls. AT&T recommends that the external auditor be permitted to apply judgment in this area and be able to utilize some of internal audit's work related to general information technology controls if the auditor assesses the internal audit function as competent and objective and the controls as mature.

If the proposed standard is adopted in its current form, the testing of general information technology controls will result in duplicative activities between internal audit and the external audit. As a result, the costs associated with these activities would appear to mitigate the benefits gained in this specific area.

Testing Operating Effectiveness

We believe, the proposed standard requires the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year. While AT&T agrees with this requirement during the initial year of implementation, the proposed standard may not adequately recognize the cumulative knowledge the external auditor gains from their results of their own testing of management's internal controls and the review of management's and internal audit's testing of those internal controls. Additionally, in instances where there are little to no changes to the internal controls the auditor should be able to utilize their judgment in determining the appropriate level of testing year to year. However, if paragraph 101 of the proposed standard does provide the external auditor the flexibility to recognize the cumulative knowledge gained from the results of previous audit work, then we are comfortable with this aspect of the proposed standard and the following comments are not necessary.

We believe that the proposed standard maybe overly prescriptive, requiring external auditors to perform the same level of testing year over year regardless of the results of the previous year control environment testing and cumulative knowledge obtained. Specifically, as it relates to rotating tests of controls for significant accounts and disclosures, we believe the proposed standard does not allow the auditor to exercise judgment regarding the level of testing from year to year on processes that have little to no change.

AT&T recommends that the external auditor be permitted to exercise judgment as to the extent of testing of controls related to significant accounts and disclosures based on their cumulative knowledge and testing results after the initial year of implementation. In order to provide a better basis for the external auditor to rely on testing by management, perhaps the Board should consider proposing broad guidelines related to the frequency of testing internal controls by management when the external auditor would apply a rotation testing approach. Additionally, it would be helpful if these broad guidelines would include the extent of management testing required that would enable the external auditor to rotate tests of internal controls regardless of whether those internal controls changed from year to year.

We appreciate the Board's consideration of our point of view and comments and we would welcome the opportunity to discuss any of these issues at your convenience. If you have any questions regarding this letter, please feel free to contact me at (908) 234-4250.

Sincerely,

N.S. Cyprus

Via e-mail: comments@pcaobus.org

November 21, 2003

Public Company Accounting Oversight Board
Office of the Secretary
1666 K Street, NW
Washington, DC 20006-2803

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

Thank you for the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB) proposed auditing standard relating to audits of internal control over financial reporting (the Proposal). Included herein are responses to the specific questions. However, we have also included several general comments that we believe warrant the Board's attention.

Section 404 of Sarbanes-Oxley (the Act) specifically requires the independent accountant to attest and report on management's evaluation of internal control and procedures for financial reporting. Financial institutions with assets greater than $500 million are already required to obtain an independent auditor attestation on management's assessment of internal controls over financial reporting. The commentary accompanying your Proposal notes that "the Federal Bank regulator representative present at the Board's Roundtable indicated that experience with the Federal Deposit Insurance Corporation Improvement Act of 1991, which requires internal control reporting similar to Section 404 of the Act, revealed instances where the auditor used the work of internal auditors to an inappropriately high degree, where the auditor himself or herself did not perform sufficient work to provide a reasonable basis of his or her opinion". We believe this statement to be reflective of the execution or competence of specific individuals and not necessarily an indictment of existing attestation standards or existing management processes in place at all financial institutions.

We are particularly concerned that financial institutions, which have developed comprehensive processes to evaluate internal controls over financial reporting will be subject to significant additional expense without corresponding benefit.

We believe that the Proposal goes far beyond the requirements of the law by requiring an audit of internal control over financial reporting, rather that an attestation regarding management's assessment of those controls. In that regard, given the breadth and complexity of the work required to perform an audit of internal controls in conjunction with the considerable differences in the manner in which internal controls are established and implemented at various organizations. We believe that independent accountants be afforded considerable flexibility in using their professional judgment to determine both the scope of their work and the extent to which they can rely on the work of others. We believe this to be particularly appropriate given the fact the independent accountant will also be required to issue an opinion on the financial statements.

We believe the Board should follow the approach set forth in statement of Auditing Standard No. 65, which allows the auditor to assess the competency and objectivity of the internal audit function and make judgments about the extent to which the work of internal audit can be ruled upon.

We also believe that the Proposal has an inherent conflict with one of the basic premises of the Act, which is to ensure auditor independence. The Act specifically prohibits the independent accountant from a range of non-audit services including internal audit co-sourcing. However, the Proposal as currently crafted has the potential to significantly increase work required by the independent accountant that could be defined as internal audit in nature. Given the significant variance in the cost structures of an independent accounting firm and an internal audit division, the Proposal could result in significant cost increases with far less actual internal control coverage.

The Act requires that audit committees be directly responsible for the appointment, compensation, and oversight of the independent accountant. Additionally, New York Stock Exchange (NYSE) Rules require audit committees to perform specific functions concerning supervision of the independent accountant's work. The Proposal requires that the independent accountant is to perform an assessment of the effectiveness of the audit committee. Accordingly, we believe the Proposal creates an inherent conflict of interest and potentially violates established independence rules. We believe that corporate governance rules established by the NYSE provide adequate requirements for review of the audit committee performance.

We recognize that the Board faces a significant and difficult challenge in developing a standard that effectively addresses concerns surrounding the reliability of financial information without creating unworkable or impractical implementation problems. We believe your consideration of our comments, in conjunction with leveraging existing standards already in place at financial institutions, would provide a standard that fulfills the requirements and intentions of the Act as well as provide flexibility to covered companies.

Selected Questions
(Numbers refer to question numbers in the Proposed Standard.)

1. No, The Act requires the PCAOB to establish standards governing the independent accountants attestation on management's assessment of the effectiveness of internal control over financial reporting. We believe the intent of the Act is to ensure that management understands its responsibility for the internal control environment and establishes sufficient processes to determine that the internal control environment is operating effectively. Correspondingly, we believe the scope of independent accountant attestation should be to determine that management has established appropriate processes and evaluation techniques. In our opinion, requiring an audit of internal control over financial reporting goes well beyond the requirements of the Act and has the potential to put the independent accountant in the roll of management as primarily responsible for the adequacy of internal controls.

2. Yes. We believe the Proposal has basically redefined what constitutes the procedures necessary to provide an opinion on the financial statements by stating that the auditor cannot audit internal control over financial reporting without also auditing the financial statements.

3. Yes. However, in reality it's still not practical to have a separate firm report on internal controls. The work they do would be duplicative.

4. Yes. Appendix E gives 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 organizations.

5. No. The Board should not establish further rules governing audit personnel's academic background or experience in auditing financial statements. There are sufficient rules governing competency of staff in the professional standards. These standards merely need to be enforced.

6. Yes. It's obvious that the auditor would need to evaluate management's assessment, and to do so they must have considerable understanding of the control environment. This was the case prior to the proposed standard and is even more apparent now. However, we believe that the auditor should be afforded considerable judgment in determining the reliance that can be placed on the work of others.

7. Yes. The criteria should provide consistency between how management documents and the documentation auditors expect to review.

8. No. Inadequate or lack of documentation should not be considered an internal control deficiency. The key is whether the controls are functioning and effective. The auditor should evaluate whether the controls are adequate. In order to do this evaluation they may need to prepare their own documentation or utilize documentation by management. There are situations in which simple processes could be determined to be well controlled without documentation.

9. Yes. Walkthroughs allow the auditor to observe the process, and confirm their understanding.

10. No. The auditor should be allowed to use walkthrough procedures performed by internal auditors. External auditors should be able, in most cases, to test and rely on the work of internal audit just as they do in the audit of financial statements.

11. No. A control should be tested initially and then only changes to the control should be required to be tested in subsequent periods. It would be inefficient to test the same control each year. A rotational testing, combined with benchmarking, should be sufficient to conclude on management's assertions.

12. External auditors should be able, in most cases, to rely on the work of internal audit. External auditors should be permitted to rely on the judgment of internal audit for testing of processes after performing an evaluation and testing of internal audit work in accordance with existing guidelines. The Proposal states that many functions must be performed and tested by the external audit firm. Many of these functions would require duplicative work by the external auditor that is excessive and unnecessary.

13. No. The audit should be risk based and not static based on three categories of controls. As stated in the response to question

Number 12, external auditors should be permitted to evaluate and rely on the work of internal audit.

14. No. As written, the Proposal may cause a reduction in the coverage by internal audit. If certain procedures are required to be performed by external auditor, management may reduce internal audit coverage in an effort to avoid duplication. Given existing cost structures as well as the specific expertise and institutional knowledge that qualified internal auditors provide, this could result in less audit coverage at a significantly increased cost

15. No. The Proposal does not give enough flexibility. The flexibility in determining the extent of reproducing the work of others should not be based on the three categories of control but be risk based with the use of sampling. Existing professional standards provide sufficient guidance on evaluating and relying on internal audit.

16. No. The Proposal is unclear and limits overall judgment. The Proposal sets requirements that are too prescriptive and limits management and internal audits judgment. Management establishes all major processes. Companies document the flow of processes. Significant work, concern, and time go into the development and documentation of processes. External auditors should be permitted to establish a basis and rely on the judgment of management and internal audit for establishment of processes and internal testing thereof.

17. No. Proposal uses the term “significant” to narrowly. The Proposal refers to “significant” as “more than remote” or “likelihood of occurrence” to refer to areas of deficiencies. This level is too low of threshold for the use of “significant” and seems to be at a lower level than current auditing standards.

18. Yes. The examples in Appendix D are helpful.

19. Yes. The auditor would need to evaluate the severity of all identified internal control deficiencies to determine if they are significant deficiencies, a material weakness or just a deficiency.

20. No. Clearly material weakness and significant deficiencies should be reported to management in writing. However, for lesser weaknesses, we believe the method of reporting should be left to the professional judgment of the auditor.

21. Yes. The matters are appropriately classified.

22. No. FFIEC and Stock Exchange rules provide for audit committee review. The FFIEC established expectations for effective audit committees. Further, the NYSE and NASDAQ established new corporate governance rules that include criteria for effective audit committees. The COSO framework also provides for assessment of internal controls and the "tone at the top".

23. No. Proposal violates the SEC auditor independence rules. The Proposal requires that the public accounting firm is to perform an assessment of the effectiveness of the audit committee. The Sarbanes-Oxley Act requires that public accounting firms report to the audit committee. Separately, the public accounting firm is hired/chosen by the audit committee and the company pays the accounting firm. External accounting firms would not be in the position to be adequately independent to opine on the effectiveness of the audit committee.

24. No. The auditor should be required to issue an adverse report, if they conclude that there is ineffective audit committee oversight.

25. No. A single material weakness is rarely the cause, but rather the combination of several material weaknesses. Flexibility should be given as to the nature of the weakness and as to whether other mitigating controls exist.

26. No. Per the Proposal, either a material weakness exists or it does not.

27. No. An audit opinion shall not be required, only attestation to managements assertion of whether internal controls are effective. Sarbanes-Oxley directs the PCAOB to establish standards governing the independent auditor's attestation and reporting on management's assessment of the effectiveness of internal control over financial reporting.

28. No. The independence rules should establish the nature of non-audit services that can be provided.

29. Yes. Consulting services as it relates to internal controls and internal audit services.

30. Yes. Requiring the auditor to provide an attestation on management's assessment of internal controls over financial

reporting is sufficient. Additionally, we believe the quarterly requirements (excluding the fourth quarter) are appropriate.

31. No. We do not believe that requiring a different level of responsibility, as it relates to changes in internal control made in the fourth quarter, is appropriate. If management identifies and corrects a material weakness, and it is reported to the audit committee with no subsequent year-end financial statement impact, we do not believe disclosure in the annual report is necessary.

Thank you for the opportunity to comment.

Francis J. McNichol
Corporate Audit
Bank of America

Jeffrey R. Watkins
Corporate Audit
Bank of America

November 21, 2003

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

Reference: 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

Ladies and Gentlemen:

Bank One Corporation ("Bank One") is pleased to have the opportunity to comment on the above referenced Proposed Auditing Standard ("Proposed Standard"). Bank One is the nation's sixth-largest bank holding company, with assets of more than $299 billion.

Bank One supports the general theme of the Proposed Standard, which requires the external auditor to take additional responsibility in evaluating the effectiveness of internal control over financial reporting. However, Bank One has two primary comments regarding specific tenets of the Proposed Standard and three additional comments where we believe the proposed guidance is either unnecessarily rigid or requires additional clarification and enhancement.

Primary Comments
In general, we believe the Proposed Standard unduly limits the reliance that can be placed upon the work performed by internal audit by not recognizing the independence of internal audit from management. It also does not permit the external auditor to exercise sufficient professional judgment and discretion when performing an audit of internal control over financial reporting. In addition, the Proposed Standard prescribes too low of a threshold to be workable when evaluating a significant deficiency or material weakness.

(1) The Proposed Standard should permit more reliance to be placed on Internal Audit and allow the external auditor more discretion when conducting an audit of internal control over financial reporting

Internal audit is chartered with providing an objective viewpoint of an organization and will, in larger organizations, functionally report directly to the audit committee (and only administratively to management). Furthermore, the audit committee must annually approve internal audit's

[1] Paragraph 42 of the Proposed Standard states, "As part of understanding and evaluation of management's process, the auditor should obtain an understanding of the results of procedures performed by others. Others include internal audit and third parties working under the direction of management, including other auditors and accounting professional engaged to perform procedures as a basis for management's assessment."

detailed audit plans, including budgets and staffing, and assess the performance of the internal audit function. This reporting alignment allows internal audit to remain independent from the decisions made by management. In cases where the internal audit department is "competent" and "objective,"[2] and where it reports directly to the audit committee, the external auditor should be allowed to rely more extensively on internal audit's test work. This includes test work performed for routine and non-routine transactions, including the routine portion of the period-end financial reporting process and walkthrough testing of significant processes.

In a financial statement audit, the external auditor is allowed to rely on the work performed by internal audit, provided that the external auditor follows the guidance in SAS No. 65. It seems only reasonable, prudent and effective that the external auditor be allowed to follow the same guidance when performing an audit of the internal control over financial reporting. Following the same guidance, the level and amount of reliance that is placed on the internal audit function would then be left to the external auditor's professional judgment and discretion.

Based on this rationale, discretion should be given to the external auditor when conducting walkthrough tests of a company's significant processes, testing of controls in the control environment, testing of controls in the period-end financial reporting process and testing of controls that may have a pervasive effect on the financial statements. For large financial institutions that are heavily regulated, internal audit may already perform the same procedures that the Proposed Standard mandates to the external auditor. As the Proposed Standard is currently written, the external auditor would be required to duplicate this effort while ignoring the competency and objectivity of internal audit. This duplication of effort will result in an undue burden on management.

We recommend that the Proposed Standard make a clear distinction between management and internal audit. Also, it should make specific reference to SAS No. 65 and allow the external auditor to follow this guidance when performing an audit of internal control over financial reporting. Finally, the Proposed Standard should allow the external auditor discretion to determine whether its direct testing or internal audit's testing will provide the primary evidence for the audit.

(2) The threshold for a "significant deficiency" and "material weakness" is too low and is inconsistent with FDICIA and SEC guidelines

The Proposed Standard requires the external auditor to issue an adverse opinion when a material weakness has been identified. However, we believe the Proposed Standard sets the threshold for evaluating what constitutes both a significant deficiency and material weakness far too low in relation to existing auditing guidance. In addition, in designing systems of internal control over financial reporting, an organization must balance the cost of the control with the benefit of assurance over accuracy and integrity of financial reporting. To design a system of internal control which adequately captures all events which are more than inconsequential in amount and which may have more than a remote likelihood of occurring may be cost prohibitive, or in some cases, functionally impractical. Furthermore, the Proposed Standard should ensure that the

[2] The terms "competent" and "objective" are used in the same context as the terms are used in SAS No. 65, *"The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements."* It would be expected under an audit of internal control over financial reporting that the external auditor would assess the competency and objectivity of the internal audit department as further described in SAS No. 65, paragraphs .09 - .11.

concepts of "significant deficiency" and "material weakness" are defined consistently with guidelines that are currently being utilized by banking regulators. This will help to ensure consistent application of the Proposed Standard and will help to reduce confusion in the marketplace.

The Proposed Standard introduces the concepts of "more than a remote likelihood" and "more than inconsequential in amount" when evaluating internal control deficiencies, creating a significantly broader and lower threshold for what constitutes a significant deficiency and material weakness than currently exists. By definition, misstatements assessed as having more than a remote likelihood of occurrence and being more than inconsequential in amount could be interpreted as inclusive of any deficiency identified during the audit of internal control over financial reporting. This essentially characterizes any internal control deficiency as a significant deficiency or material weakness. This could result in the external auditor improperly classifying any deficiency as significant or material when such deficiency may actually have a minimal impact on the financial statements. Furthermore, we believe that the definition of a significant deficiency and material weakness in the Proposed Standard is inconsistent with the concept of "materiality" as described in Staff Accounting Bulletin (SAB) No. 99, *"Assessing Materiality."* These terms should be consistent if an auditor is to report on both the financial statements and on internal control over financial reporting.

Assuming that it is not the Board's intention to require *all* identified deficiencies to be classified as either significant deficiencies or material weaknesses, we recommend that the Proposed Standard clarify that the threshold for both a significant deficiency and material weakness is a level where the risk of misstatement is "at least reasonably likely" and "material." This would provide consistency with the "reasonable assurance" and "reasonable likelihood" terminology utilized in Paragraph 183 of the Proposed Standard and similar terminology used in SAB No. 99.

The definitions of material weakness and reportable conditions, as defined in SAS No. 60, are widely accepted and used in current practice to make assessments on internal control over financial reporting under the FDICIA Act of 1991. The Proposed Standard creates the possibility of inconsistency in reporting on internal controls as financial institutions are subject to both FDICIA regulations and Section 404 of the Sarbanes-Oxley Act of 2002. Based on current guidance, financial institutions would be required to report reportable conditions and material weaknesses on two different levels of criteria. This could result in conflicting assessments on internal control over financial reporting by management and the external auditors during the same time period. This could cause inconsistency in the reporting on internal control over financial reporting to investors and regulators. We recommend that the Proposed Standard utilize the definitions in SAS No. 60, *"Communication of Internal Control Matters Noted in an Audit,"* SAB No. 99 and FDICIA.

Additional Comments:

(3) The Proposed Standard should not prescribe what circumstances constitute a significant deficiency or material weakness

In paragraph 126, the Proposed Standard lists specific circumstances that should represent, at a minimum, a significant deficiency and could be a strong indication of a material weakness. A material weakness or significant deficiency should be based on facts and circumstances unique to the underlying situation. It should not be prescribed in a list that precludes or inhibits the external auditor's professional judgment and discretion.

While we agree certain circumstances may be more indicative of a significant deficiency or material weakness, each underlying situation should be evaluated according to the facts and circumstances and should be based on the external auditor's judgment and discretion. The Proposed Standard should be amended to provide that the circumstances in Paragraph 126 be characterized as indicators, not requirements.

For instance, when financial statement audits are performed, differences in views between management and the external auditor concerning judgments related to the interpretation and subsequent application of complex accounting standards or judgments in estimates and assumptions may arise. When significant judgment is involved in the interpretation and application of complex accounting standards for which current guidance is vague and subject to interpretation[3] or when there is significant judgment pertaining to valuations and estimates, there may be times when the resolution of differing views could result in a proposed audit adjustment even though adequate and effective controls over financial reporting may be in place.

(4) The procedures and scope of work to be performed by external auditors when providing a consent on the report of internal control over financial reporting

In paragraphs 181 and 182, the Proposed Standard requires that the external auditor perform bring-down procedures from the date of his or her report on the internal control over financial reporting to the date of the consent. However, the Proposed Standard is silent on (1) the types of bring-down procedures the external auditor is expected to perform and (2) the level of comfort that the external auditor is expected to provide in a consent. The Proposed Standard would be better served if it provided general guidance on the types of procedures that external auditors are to perform when providing consent to reissue the report on internal control over financial reporting. In addition, the Proposed Standard should clarify that the scope of an external auditor's bring-down procedures would be to identify any adverse changes in internal control over financial reporting during the intervening period that would have had an impact on the external auditor's report.

(5) Scope extension to contingent liabilities

Paragraph 74 of the Proposed Standard requires that the external auditor obtain evidence about the effectiveness of controls for all relevant assertions related to all significant accounts and disclosures in the financial statements. Appendix B, paragraph B19 provides guidance that an auditor should follow in identifying significant accounts related to contingent liabilities.

[3] SFAS No. 133, SFAS No. 140 or FIN No. 46 are just a few complex accounting standards where there is neither accounting consistency across companies nor consistency across external audit firms regarding all interpretations. SFAS No. 133, SFAS No. 140 and FIN No. 46 refer to the following accounting standards: Statement of Financial Accounting Standards (SFAS) No. 133, *"Accounting for Derivatives and Hedging Activities,"* as amended by SFAS No. 138 and SFAS No. 149; SFAS No. 140, *"Accounting for Transfers and Servicing of Assets and Extinguishment of Liabilities – a Replacement of FASB Statement No. 125"*; and FIN No. 46, "*Consolidation of Variable Interest Entities – An Interpretation of ARB No. 51."*

We believe the scope of the Proposed Standard is excessive in requiring the external auditor to assess the potential impact that contingent liabilities may have on the financial statements or disclosures thereto when such contingent liabilities are inconsequential (or not reasonably estimable) and the likelihood of occurrence is less than probable.[4] The example in paragraph B19 would suggest that the external auditor evaluate all contingent liabilities (legal, environmental, etc.) for which there is a remote possibility of occurrence but could have a significant potential impact on the financial statements. While it is necessary to have controls over financial reporting related to the capture of contingent liabilities, the Proposed Standard should limit the scope of the audit work that external auditors need to perform. External auditors should only be required to evaluate the internal controls related to identifying, processing and disclosing material contingent liabilities.

Bank One appreciates the opportunity to comment on the Proposed Standard. If you have any questions on this comment letter or would like any additional information, please do not hesitate to contact either Melissa J. Moore at (312) 336-4060 or Jeffrey T. Rigg at (312) 954-3311.

Very truly yours,

Melissa J. Moore
Controller and
Chief Accounting Officer

Jeffrey T. Rigg
General Auditor

[4] The terms "probable" and "reasonably estimable" are used in the same context as paragraph 3 of SFAS No. 5, *"Accounting for Contingencies."*

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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

Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*

Dear Mr. Secretary:

BDO Seidman, LLP respectfully submits the following comments on the Public Company Accounting Oversight Board's ("PCAOB" or "Board") proposed auditing standard ("the proposed standard") governing the independent auditor's attestation and reporting on management's assessment of the effectiveness of internal control over financial reporting referred to in Sections 103(a)(2)(A) and 404(b) of the Sarbanes-Oxley Act of 2002 ("the Act"). BDO Seidman, LLP is pleased to serve on the Task Force of the PCAOB considering implementation issues and the AICPA Task Forces that developed draft standards prior to the effective certification date of the PCAOB, and since that date has been discussing practical implementation issues.

We recognize the importance of establishing and enforcing standards that will restore confidence in our financial reporting environment and are anxious to participate further in the initiatives of the PCAOB and other regulatory bodies to advance the quality of our professional standards. We appreciate the dedicated effort necessary to develop quality standards.

In addition to the direct questions posed by the Exposure Draft, there are several overarching points related to the proposed standard we would like to communicate, as follows:

Lack of Preparer Guidance

We have previously communicated to the PCAOB (Letter dated August 6, 2003 to Douglas R. Carmichael, Chief Auditor) our concern that the preparer community lacks effective guidance relating to the extent of documentation and testing required to meet its responsibilities under Section 404 of the Act and the related SEC rules. In the absence of such guidance, the auditor must apply judgment on a case-by-case basis when assessing the adequacy of the documentation and testing performed by the preparer to support its assertion. We find it unreasonable to require the expression of an audit opinion covering a subject matter that is effectively "undefined."

Preparers are anxiously seeking guidance from their auditors as to their documentation and testing responsibilities under the Act and SEC rules. It is possible that auditors providing this guidance might be misconstrued as providing legal advice, or impairing the independence of the auditor. We understand that the PCAOB may not be able to mandate preparer responsibilities. We do acknowledge the criteria for auditor evaluation of preparer documentation in the proposed standard, which we believe are very helpful. However, we urge the PCAOB to work with the SEC to provide the necessary implementation standards and guidance to the preparer community.

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Lack of Preparer Document Retention Guidance **-** The final standard should be expanded to include guidance relating to the retention of internal controls documentation and testing by the preparer. This is especially important in this standard, as auditors have not previously performed audits of internal controls as now envisioned.

An issue related to both audit documentation and the lack of current preparer guidance, is the lack of any specific documentation retention requirements for preparers. For example, some preparers are currently documenting and testing their internal controls using web-based tools. These systems may be set up so that documentation can be updated on a contemporaneous basis as elements of the systems change. In addition, preparers may use a proprietary software product to document their activities and software-licensing issues could make it difficult for the auditor to obtain or utilize the assessment. We believe that preparers should maintain an archived copy of the controls documentation that relate to each year's management assertion. We also believe that any software, licenses or tools needed for the auditor to review the documentation of the entity should be made available by the entity. In the absence of assurances that such documentation will be retained, the auditor may need to obtain copies of the preparer's documentation to include in the auditor workpapers and retain such documentation as evidence of the documents reviewed. In that regard, we believe it is inappropriate and inefficient for auditors to become the repository of corporate records.

This issue is broader than audits of internal controls, but has arisen as particularly troublesome in this context. Many preparers in our marketplace that have begun their 404 projects related to the internal controls documentation and testing had not initially considered this issue in their plans.

Some may believe that such an archived, indexed record may already be required under regulations requiring the retention of documentation supporting matters contained in SEC filings or under the existing "books and records" provision of the 1934 Exchange Act (13(b)). We do not think these provisions are currently worded broadly enough to clearly require the retention of management's support for its 404 assertion. Nevertheless, we have observed that the need to retain such documentation has not been universally recognized as a requirement by all preparers. Therefore, the final standard should include "the adequate retention of documentation of controls, evaluation of design effectiveness, and testing and monitoring of operating effectiveness" as an expected attribute that could, if absent, be a presumptive indicator of a material weakness.

Overall Efficiency of the Standard

While we believe the auditor's attestation regarding the effectiveness of internal control should contribute to better financial reporting, the underlying standard should recognize that there are a number of elements of existing auditing requirements and recent regulatory actions that already provide a significant measure of cost-effective public protection and risk reduction. Notably:

- The Implementation of Corporate Anti-Fraud Programs (recommended in Statement of Auditing Standards No. 99 "Consideration of Fraud in a Financial Statement Audit " and a component of an effective corporate control environment under the COSO framework)
- The implementation of the required auditing procedures and inquiries outlined in SAS 99, which are being applied for the first time this year.
- Improvements in the investigatory and legal processes wherein corporate executives will be investigated and prosecuted for fraud.
- Improvements in corporate governance to ensure independent and competent directors and effective audit committees

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- A more effective industry-wide inspection program to ensure firm compliance with the form and substance of the standards, and to ensure the firms' focus on the proper "tone at the top" in their organizations.

In that context, we are concerned that the current proposed standard requires redundant and excessive procedures to be performed by the auditor during an audit of internal controls. While we acknowledge the importance of significant auditor involvement in testing the work of management, in many places the auditor is required to go well beyond the traditional audit concept of testing and examining evidence. For example, the auditor is required in all significant processes to perform all the walkthrough procedures, and to perform all the procedures necessary to assess general controls and the control environment. We believe these requirements will not significantly contribute to more effective internal controls audits, and will unnecessarily raise the related auditing costs. We recommend the final standard better reflect the concept of testing by the auditor. Of course, this is subject to evaluating the objectivity and competence of internal auditors, contracted service providers, management or employees performing the documentation, testing and monitoring required of companies by the Act.

We have provided specific suggestions regarding this matter in our responses to questions 10, 14, 15 and 20.

The Proposed Auditing Standard Does Not Create a Cohesive and Comprehensive Body of Auditing Literature

In addition to addressing the issues related to the reporting and performance of audits of internal controls, the proposed standard modifies existing literature not directly related to the audit of internal controls.

For example, paragraph 138 states that "the auditor should perform substantive procedures for all relevant assertions for all significant accounts and disclosures" (emphasis added). Also, paragraph 141 states that "the auditor's substantive procedures must include reconciling the financial statements to the accounting records." These new audit requirements are not related to the audit of internal controls. While we believe these requirements are appropriate, and believe they are consistent with the "risk assessment" Exposure Draft of the AICPA, we are concerned about their subtle placement in this document.

These issues are neither highlighted in the text nor discussed in the briefing paper. Thus readers might not identify these changes in the literature. Additionally, if the existing AICPA standards adopted by the PCAOB as interim standards are not marked for conforming changes, the body of auditing literature applicable to audits of public companies may become confusing and contradictory. We strongly recommend the PCAOB clearly indicate any and all changes to its adopted interim standards as part of its exposure process.

It is our understanding that the body of AICPA standards applicable to private company audits conducted under AICPA standards will continue to grow and evolve. We assume the interim standards adopted by the PCAOB would not reflect changes in the AICPA standards after their adoption date as interim standards, and therefore that literature would be static for public company audits unless modified by the PCAOB. Therefore, it is likely that the two bodies of standards will diverge over time. Accordingly, to make the auditing literature relating to public companies clear and to maintain quality auditing in public company audits, we strongly recommend a "marked for changes" version of any paragraph or section edits of the adopted

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interim standards necessary as conforming changes be released with the new adopted standards of the PCAOB.

While we support the PCAOB's development of quality control standards, we recommend that they be presented in the appropriate section of the PCAOB Professional Literature. If there are very narrow implementation issues relating to a subject matter of a standard, we do not object to including that narrow guidance in a section of the auditing standard, but encourage such guidance to also be repeated in the PCAOB Quality Control Literature, where it otherwise would be expected to appear.

Effective Date

It is our understanding that after approval of a final standard by the PCAOB, an additional exposure period by the SEC is required. Therefore, a final "published" rule is unlikely until well into 2004. We believe this will not provide time for issuers to complete their documentation, evaluate and test controls, and correct any deficiencies identified, nor an opportunity for the auditing firms to ensure the requisite trained personnel are in place to perform the procedures required by the final standard. Most firms will find it impossible to provide timely training on the final standard during the "busy season," even though many auditors already have orientation and training in the subject matter.

Under these time constraints we see a risk that the implementation of the final standard for accelerated filers that must begin reporting on internal controls for years ending after June 15, 2004 will raise the potential for mistakes and misunderstandings that could undermine the intention of this requirement to restore investor confidence.

In that regard, we urge the PCAOB to make a recommendation to the SEC to delay the effective implementation of the final standard for accelerated filers. We believe it appropriate, assuming no further delays in issuing the standard, to require the audit of internal controls to accompany the financial statements of entities whose fiscal years end on or after October 15, 2004, but no earlier than six months after the final standard is published.

PCAOB Comment Letter – Draft Responses to Questions

Questions regarding an integrated audit of the financial statements and internal control over financial reporting:

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?

Yes. We believe the "audit" terminology clearly communicates the service being performed to users of financial statements and distinguishes the service from an attestation service performed under the standards of the AICPA which we believe should still be available to public entities for internal or other purposes.

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?

Yes. We believe that the auditor performing an audit of internal controls under the PCAOB auditing and related standards must also audit the financial statements. This is a clear requirement of Rule

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2-02 of Regulation S-X and is mandated by Section 404 of the Sarbanes-Oxley Act.

It is our understanding that the final standard will replace the current AICPA AT Section 501 guidance in the PCAOB standards literature. In that circumstance, there would be no public company auditing literature guiding an attest service relating to internal controls unless performed in conjunction with an audit of the financial statements. However, we can envision a circumstance where such an attest service might be requested without requiring a full financial statement audit, such as a pre-merger attestation to evaluate to the effectiveness of controls of that entity as of a specific date or an attestation engagement for an interim financial period. In our view, an attestation service can be performed under AICPA AT 501 standards in such circumstances.

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?

With respect to the required audit of internal controls accompanying the annual audit of the financial statements, we believe the rules are clear that a division of auditor responsibility is not permitted, and thus the concept of "comparable" work is not relevant in that context.

Questions regarding the costs and benefits of internal control:

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?

No. We believe the proposed standard does not give adequate guidance on how internal control audits differ when conducted for small and medium size businesses. While we do not believe there should be a lower standard for evaluating or reporting on the effectiveness of internal controls in smaller enterprises, we acknowledge the techniques of auditing the internal controls of such smaller issuers will likely differ.

We believe the example in the Appendix, suggesting that management oversight might compensate for a missing or ineffective control, improperly implies that management supervision is an acceptable alternative to controls. We believe such an implication may be used by many entities to excuse missing or ineffective controls. However, recent history is replete with examples where management is the problem, and not the control.

We also think it inappropriate that the responsibility for defining the different small company environment and the associated audit responsibilities in these environments rests with the auditor. We are not aware of any guidance that would aid in achieving a consistent approach across companies and among firms on this issue. Absent guidance tailored to the small and medium sized issuers or changes in the reporting options, the proposed standard will likely result in a large proportion of smaller issuers receiving adverse opinions.

We do not feel a remedy for this is to weaken the value of an unqualified opinion on internal controls for smaller entities. The public will be unable to identify when an unqualified audit report may mean something different because the entity's controls were evaluated according to a small entity standard. We would rather see a deferral of the implementation date for smaller entities (perhaps using a non-accelerated filer definition) pending further research and experimentation in providing and reporting on this service.

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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.

No, we believe this level of guidance in the public company auditing standards is unnecessary and not a response to an identified issue. We believe the interim AICPA standards adopted by the PCAOB adequately address this issue in the existing general and field work standards for auditing and attestation engagements.

Questions regarding evaluation of management's assessment:

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, both management's assessment and the underlying effectiveness of internal controls are important for the auditor to consider when rendering an opinion on internal controls. Management's assessment is a public communication that has great flexibility permitted in its form and content. That document should not be misleading by commission or significant omission or a presentation that obscures important information from the reader. To render an audit report on internal controls, the auditor must accumulate sufficient evidence of controls effectiveness.

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

Yes, we believe that providing examples of such criteria are appropriate. As we stated earlier, we suggest the final standard also list the preparer's failure to plan for and retain (archive) its documentation of its controls and its evaluation, testing and monitoring to support its assessment as a potential material weakness.

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?

Yes, we believe it appropriate to require the auditor to assess the significance of the deficiency on a case-by-case basis. At this time, as commented previously, law or regulation does not specify the level and format of documentation required of preparers. In the absence of such guidance or a benchmark, we do not believe that an imposition of an automatic categorization of an undefined condition as a significant deficiency or material weakness will have any value in user reporting. We do encourage a re-visitation of this point if either by practical experience in applying the requirements or legislation, a more objective definition of what constitutes "inadequate documentation" can be developed.

Paragraph 46 says: "In evaluating the deficiency as to its significance, the auditor should determine whether management can demonstrate the monitoring component of internal control over financial

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reporting in the absence of documentation." We do not understand how, if an objective and clear definition of a documentation deficiency can be agreed, obvious documentation deficiencies can be overcome in such cases, and in the absence of any such rationale, recommend this guidance be changed to state affirmatively that documentation deficiencies ordinarily cannot be overcome.

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. Walkthroughs to confirm the auditor's understanding of the design and implementation of controls are well established in auditing practice, and we believe would be performed in many circumstances, even if not required. We concur that such procedures are important to perform, but also caution that they do not provide sufficient evidence of manual control operations. They are simply a "sample of one."

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?

We believe it important that auditors perform many of the critical walkthroughs for significant systems and accounts. However, we believe that walkthroughs performed by others (assessed as competent and objective) on all controls and to a greater extent on less critical control operations, could be tested by the auditor to still achieve a high degree of audit assurance, in lieu of requiring that they be redundantly performed 100% by the auditor. Following this approach would represent a significant cost saving to businesses over the proposed approach. We believe a properly implemented testing approach would accomplish the desired protection for the pubic at a lower cost.

Additionally, we believe that the current wording of the standard would require that, say, if revenue were identified as a significant account, then walkthroughs of <u>all</u> revenue processes, regardless of their significance or materiality are required. Paragraph 79 of the draft states the requirement that the auditor "should trace <u>all</u> types of transactions and events, both recurring and unusual, from origination through the company's information systems until they are reflected in the company's financial reports." The extent of work required by setting the scope to <u>"all"</u> could be extraordinary for a large, distributed enterprise, and is inefficient.

We believe the concept of a "significant process" in this proposed standard when used as a basis for assessing which controls require walkthroughs, for example, has a profound impact on how management and the auditor view the controls for an entity. We believe it worthwhile to provide examples of what the proposed standard intended by the use of this term. This is fundamental to a common understanding between the auditor and preparer.

A remedy that should be considered is the requirement to consider measures of significance or materiality when identifying the necessity of performing walkthroughs, and whether the auditor in all circumstances must perform such walkthroughs.

Currently, we believe the guidance in paragraph 79 of the proposed standard requiring auditor walkthroughs is in conflict with the guidance in Appendix B 13. Under B13, "locations or business units that are not important, even when aggregated with others" do not require any auditor action. Yet, the provisions of paragraph 79 might require a walkthough of a transaction type at these

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locations. Furthermore, if the location was not previously documented and tested by management, then the walkthrough of a transaction to "confirm" the documented control makes no sense. We therefore support the documentation, assessment and selective testing of all locations by management if the auditor might have some responsibility to perform procedures at those locations

We support the broad performance of walkthroughs by management in more instances than required of the auditor as an element of their procedures to support their assertion.

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?

We believe that evidence needs to be accumulated annually that controls are effective in order to issue an audit report on internal controls. In our view, management needs to fully test these important elements to the extent necessary to provide a high degree of assurance annually as part of their monitoring function. However, from an audit perspective, once it is established that a control is effective, and a system as well as the environment in which it operates has not changed, the passing of a calendar date alone should not change that basic conclusion.

With respect to the most critical controls over all relevant assertions for all significant accounts, we believe that at a minimum the auditor devote some attention each year to each of those controls. However, we believe it would be more efficient, with no loss of effectiveness, to encourage the rotation of testing emphasis on controls (not the rotation of controls testing). While some controls might, based on a risk assessment and entity testing findings, warrant extensive testing annually by the auditor, we believe a more effective audit could be performed when the auditor would be encouraged to focus on certain controls on a periodic basis, extending the analysis and testing of some of these controls As reflected in SAS 99, varying the nature and extent of procedures performed from year to year is an effective strategy to achieve a high degree of assurance on the subject matter and prevent/detect fraud. On balance, the increased depth of testing in some areas should compensate for the lesser level of testing in others.

We believe this concept is already reflected in paragraph 101 of the proposed standard. However, if this was not intended, then the proposed standard should be clarified.

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?

The auditor should be permitted to use the work of management and others within or engaged by the company to the extent supported by the auditor's assessment of their objectivity and competence. Generally, management would not be considered to be as objective as those outside the entity or of internal auditors, and their work might not be relied on, or relied on significantly less than if an outsourced competent service provider or objective internal audit function performed the same work.

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We cannot identify any circumstances where the auditor should be required to use the work of management or others within or engaged by the company. Since the independent auditor has the professional responsibility for his or her opinion, such a requirement would be inappropriate.

However, we acknowledge that the engagement of specialists by auditors may be more frequently encountered than before under this standard due to the specialized nature of many topics in, for example, information technology based controls. Where an engagement team does not possess the requisite skills and knowledge to evaluate the design of or perform tests of a complex, technology based control, for example, a resource should be engaged to assist the auditor. In these cases we would expect that the auditor would continue to follow the provisions of SAS 73.

We also ask the Board to clarify whether its guidance in the proposed standard (Appendix B) on the use of service organizations is intended to modify the exiting SAS 70 literature, and if so, how. One area of likely significant implementation questions will include the role of service organizations and SAS 70 reports as they relate to the required audit of internal controls.

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

We believe the categories are appropriate and helpful as a conceptual aid for auditors to understand the requirements of the proposed standard. However, as noted in several of the following responses, we have concerns that the proposed auditor requirements related to these three categories require adjustment in the final standard.

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?

Yes to the first question. Appropriate recognition is given to the value internal audit can bring to the organization and the overall audit process.

But the answer to the second question is more complicated, as we feel the mix of procedures required in the proposed standard is inefficient and ineffective.

We do not agree with the proposed standard's requirement that all the assurance the auditor receives with respect to general controls and IT controls need come solely from the auditor's procedures. In circumstances where the objectivity and competence of the internal auditor or others is assessed as high, we believe it appropriate and cost effective to permit some assurance be taken for work performed by others in these areas. We concur with the assessment of the importance of these areas overall, but believe the objectives can be achieved by requiring that most, but not necessarily all, assurance come from the independent auditor's procedures.

We also do not agree with the proposed standard's requirement that the auditor can rely "without limitation" on the work of others with regards to controls over routine processing. This can be interpreted as permitting the auditor to rely solely on others for this work. We believe it inappropriate to permit such limited involvement in controls over transactions that constitute a large portion of the transactions processed by most entities. We support the requirement in paragraph 107 that the auditor reperform some procedures as a basis for reliance and conduct some independent tests of the controls over routine processing. We believe that most of the assurance in this area could come from work performed by others who are assessed as objective and competent. However, we are mindful that many of the unfortunate incidents leading to corporate failures took place in

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organizations that had internal audit staffs that were assessed as objective and competent. Thus, we believe in all circumstances the auditor should perform some procedures in each category of classification of controls.

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)?

We believe that it is appropriate in this standard to provide flexibility in the extent of reperformance required in a particular circumstance. Paragraph 107 states that if the auditor intends to use the work of others, "the auditor should reperform some of the tests of controls originally performed by others." This level of guidance seems appropriate.

We believe it would be inefficient, and without an associated reduction in risk, to require the reperformance of each test performed by others on which the auditor intends to place some reliance. When work is performed by individuals or separate organizations (whose objectivity and competence is separately assessed) we believe it would be appropriate in the application of reperformance guidance to confirm the assessment of the competence of the work of that person by reperforming a sufficient level of that work to corroborate the competence with which the work was performed. Thus, a strong Firm-wide organization of internal auditors could require fewer reperformance tests to achieve the auditor's objectives than a loose organization of independent contractors performing the same procedures at different locations. In general, we believe the objectives embodied in the word "all" can in many instances be achieved at a lower cost and without a loss in quality if careful consideration is given to the principles of testing.

16. Is the requirement for the auditor to obtain the principle (sic. principal) 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?

Yes. However, it needs to be explicitly recognized in the standard that this is an auditor judgment, and not subject to an exact mathematical measurement.

Questions regarding evaluating results:

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 our view the use of the concept "remote likelihood" in the definition of a significant deficiency will needlessly and inappropriately sweep many issues into this category. We would favor a tolerance threshold that is considerably higher than remote (e.g., reasonably possible).

We urge the PCAOB to continue to gather practical examples and further develop this guidance as professional experience grows in this area.

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?

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Yes. We encourage the PCAOB to consider an outlet such as a "Q&A" publication that can help create more consistent applications. The examples seem rather clear cut, but the more difficult decisions will be in the gray areas.

Our comments in other sections of this letter extend to the examples provided.

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

Yes. It is necessary to make judgments of the significance and severity of all identified deficiencies We do not believe the profession yet has the requisite experience in these areas to set narrow guidelines requiring a specific treatment for specific identified deficiencies that are less than significant.

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?

No. Paragraph 191 refers to deficiencies from all sources such as regulators, internal auditor reports, etc. We believe that for a large and complex organization this is an unreasonable requirement that will be very costly. We believe that isolated and insignificant deficiencies may need only be communicated to local management. Deficiencies identified by internal audit or regulatory auditors or others that have already been communicated to management should not have to be repeated by the auditor. The requirement to prepare a written report should be limited to deficiencies that, in combination with other deficiencies, raise the risk of a potential significant deficiency in an account, assertion or location, plus all significant deficiencies and material weaknesses found. We note that an audit committee may request a written report of all deficiencies of any nature and significance. However we do not feel such a report should be mandated.

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

Yes. However, see our response to question 22 with respect to the proposed separate evaluation of the audit committee. We believe that the indicators listed in paragraph 126 should also include "the absence of sufficient evidence to support the responsible party's evaluation of the operating effectiveness of internal control constitutes a material weakness," as suggested in the AICPA draft standard forwarded to the PCAOB.

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? <u>And</u>

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

Corporate governance is a critical component of the control environment. The audit committee, as that role has been strengthened recently by the rules of the stock exchanges, is an increasingly important element of the governance process. However, we disagree with the requirement in the proposed standard for the auditor to assess the effectiveness of the audit committee as a separate element of the internal control environment in order to determine whether a weak audit committee might be indicative of a material weakness in internal controls. COSO acknowledges the importance of the audit committee function, but does not single out this function. Rather, it considers it within the context of the board of directors and other Control Environment elements.

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We believe it is not possible for the auditor to provide implicit assurance on the effectiveness of the audit committee. In our view, the auditor is not in a position to observe all the meetings, communications and actions of the audit committee as a basis for making such an assessment. We have difficulty envisioning the evidence and procedures that would support this assessment. While an auditor may be able to distinguish some weaker from stronger audit committees, and may observe an act or condition calling into question the effectiveness of the committee, an overall assessment of effectiveness is still a very subjective assessment.

Moreover, since the auditor is hired and retained by the audit committee, the requirement that the auditor conclude separately on the effectiveness of the audit committee creates a clear conflict. The imposition of such a requirement will likely hinder effective and open communication between the audit committee and the auditor at a time when better communication should be encouraged.

We also ask that regulators and the PCAOB understand that smaller entities have been responding to the requirements that audit committees improve in quality, but this is an ongoing process. The imposition of a requirement at this time to separately assess the audit committee may not have the desired effects on communication and continued improvement.

We urge that the final standard not require a specific assessment of the audit committee, but acknowledge its place within the governance structure and control environment.

If the final standard continues to require a separate assessment of the audit committee, we suggest the standard also make clear that management must also make a separate assessment of the audit committee as a basis for management's assertion

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

See response to question 22 above.

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. We see no basis for requiring the auditor's withdrawal from the engagement nor any benefit to the investing public or the business community from leaving the entity without an auditor based solely on this one issue. We believe that communicating this weakness provides better information for investors than the lack of an auditor's report resulting from the auditor's withdrawal. We believe that regulatory action would be more effective than auditing standards as a way to correct such deficiencies.

Questions regarding forming an opinion and reporting:

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?

No. We believe there are circumstances where the issuance of an "except for" opinion by the auditor is appropriate. While Item 308 of Regulation S-K precludes an unqualified opinion where

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there are material weaknesses, we believe that a qualified opinion is not precluded. Furthermore, the adopted interim standard AT 501, which the SEC specifically cites in its conclusions, precludes an unqualified opinion in the presence of a material weakness, but permits a qualified opinion.

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

Yes. For example, if a merger occurs at or near year-end, it may not be practicable to identify or correct any material weaknesses in internal controls of such entity in the short time between acquisition date and the year-end. In those circumstances, it seems unnecessarily harsh to require an adverse opinion unless the acquired business is highly significant to the consolidated entity. This may be common in the acquisition of a private entity where an opinion on internal control has not previously been rendered. To require an adverse opinion would present the issuer in an inappropriately bad light and could even chill the market for acquisitions made late in the year. In those cases, it would be appear more informative for the user to issue a qualified opinion.

In many smaller entities it will be impossible to create an effective segregation of duties over some functions to avoid a material weakness. Similarly a qualified opinion is more useful to readers than an adverse opinion when other compensating controls have been established and are operating effectively.

We are also concerned that the excessive use of the adverse opinion resulting from the guidance in the proposed standard will lessen the potential message to readers when such a conclusion is truly warranted. We believe that adverse opinions should provide a signal of the magnitude of a pervasive weakness such as when there is severely inadequate documentation or testing or an inattention to internal controls in general.

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?

We believe the auditor's report should be clear that it covers the effectiveness of internal controls in all cases. We do not believe the extent of work required to attest to management's assertion rather than to issue an audit opinion on internal controls should differ.

It is our view that the issue of the auditor's attesting to management's assessment has already led to significant confusion in the business community as to the auditor's role and extent of procedures that auditors are required to perform to issue such a report. We believe the user community will better understand the nature and extent of auditor involvement when an auditor issues an opinion on internal control.

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?

If the PCAOB intends to include narrow, subject focused guidance on the subjects in this standard, that guidance should also be repeated in the Independence and Quality Control sections of the PCAOB literature. We think that the SEC independence guidance and the guidance in this standard are sufficient at this time.

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We acknowledge the PCAOB's authority to write the auditing standards for public companies in whatever format it wishes, but think that to the extent that its proposed structure for its literature will be organized somewhat along the lines of the existing literature will be more useful. Accordingly we believe it should not commingle general independence, attest and general quality control standards guidance with auditing performance and reporting standards.

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

Yes. We believe the SEC has provided significant guidance in this area, and those examples need not be repeated here.

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, we believe that differing levels are appropriate, but urge the Board to not expand the Section 404 requirement to cover or appear to cover quarterly procedures regarding internal controls. See our response to question 31.

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

Paragraph 186, in referring to quarterly procedures states "Determine, through a combination of observation and inquiry, whether significant changes in internal control over financial reporting may introduce significant deficiencies or material weaknesses in the design of internal control over financial reporting". We believe that in using the terms "observation" and "Determine," this requirement goes beyond the nature of procedures required for reviewing financial reporting information required under SAS 100, and is an expansion of scope we do not support.

In that regard, we believe the auditor's procedures regarding controls at the interim period should be limited to inquiries, and in the case of inconclusive or contradictory information, the auditor should apply whatever procedures considered necessary to resolve the issue.

In addition, review procedures are not determinative, but rather are a basis for creating an awareness of any material modifications necessary in the circumstances.

We also have not been able to conclude whether quarterly closing and related controls are intended to be swept-in under the Section 404 audit standard. However, we find no legislative, regulatory or other support to expand the 404 requirements to cover controls over interim reporting. We encourage the PCAOB to clarify its intention. We do not support including such procedures at this time.

If quarterly internal control procedures are required by the PCAOB, it would be most logical that they be required to be performed contemporaneously with the quarterly filing and the nature and extent of procedures be defined to promote consistency in application. While a retrospective evaluation of the quarterly closing and reporting controls may be possible, the risk of a weakness being identified in a subsequent procedure, after management has certified to the period, is an

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undesirable result. We note the quarterly reporting timeframe is currently significantly constrained due to shortened filing times for accelerated filers, and increased involvement by the auditors in the review of financial information under SAS 100.

Any requirement that Section 404 engagements include interim controls tests should also be communicated to preparers, as some preparers are not currently including quarterly procedures in the scope of their Section 404 projects.

If quarterly responsibilities related to internal controls (beyond inquiries) are imposed, we believe that they should only become effective for the first quarter following the first annual reporting period for which a Section 404 audit opinion is rendered. Prior to this date, management's documentation, testing and monitoring over these quarterly controls may not be in place, and the auditor might not have an adequate basis for making an assessment. Moreover, such timing would be consistent with the SEC's transition approach for Exchange Act Rules 13a-15(d) and 15d-15(d), which require issuers to begin evaluating changes in internal control over financial reporting on a quarterly basis. Issuers are not required to comply with these rules until the first periodic report due after the first annual report that must include a management report on internal control over financial reporting.

Other Matters

Sampling

We believe the first sentence in the second bullet in paragraph 102 is incorrect as stated. In general, sample sizes for tests of controls do not increase as the number of control procedures increase. The exception to the rule is that for very small populations (say, less than a couple of hundred items), fewer items need to be examined. The example given is a small population of controls operating infrequently, and small populations such as this do require fewer items to test. However, the general statement in the first sentence is not supported by sampling theory or the guidance in the Audit Sampling Guide. Since attribute samples are seeking comfort that exceptions do not exceed some tolerable rate, increasing population size (once a threshold population size is reached) does not increase the required sample size.

The sentence referred to is generally true in all cases where substantive tests based on dollar values is performed. In a substantive test, the precision of the substantive test is linked to materiality (which is a specific amount), so, as the population grows, the sample size necessary to test for misstatement grows. We do not believe that the proposed standard intended that tests of controls be designed as substantive tests, using materiality thresholds to drive the sample size. Therefore, we believe the sentence should be corrected or clarified.

The Relationship Between Preparer and Auditor Test Levels

A common question asked by preparers is how much testing are they required to perform. As we mentioned earlier in this comment letter, this is a result of the lack of guidance for preparers. This often brings into question the relationship between the extent of testing of auditors and that of preparers. It is our view that the final standard should reflect that when auditors have assessed the documentation and testing by management and concluded that management has achieved a high level of assurance that their assertion concerning internal control is supported, that auditor test levels can often be expected to be less than those used by management. This is because the auditors have a significant and important piece of evidence the preparer did not have prior to their testing – management's analysis and test results. Thus, the levels of tests by management to

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achieve a high assurance of effective operation should be greater than the levels required of auditors in their tests of internal control.

The Use of the "All" Requirement in the Proposed Standard

When the term "all" is used it provides no room for judgment for application of procedures that are effective and efficient. We believe the term "all" applies more appropriately to management's need to be very thorough in identifying, documenting and testing controls. It has been a long-standing practice that the auditor could practically and economically limit his or her procedures by testing. While we can envision circumstances where "all" might be the right scope, in many cases it will cause the performance of unproductive and expensive procedures. Examples from the proposed standard include:

> 114 As part of this evaluation, the auditor should review ***all*** reports issued during the year by internal audit (or similar functions, such as loan review in a financial institution) that address controls related to internal control over financial reporting and evaluate any internal control deficiencies identified in those reports.
>
> 191 In addition, the auditor should communicate to management, in writing, ***all*** deficiencies in internal control over financial reporting (that is, those deficiencies in internal control over financial reporting that are of a lesser magnitude than significant deficiencies) identified during the audit and inform the audit committee when such a communication has been made.

We recommend that the final standard reconsider the use or concept of "all" throughout the document. In our view, if the preparer has done a good job in documentation, testing and monitoring, and has demonstrated an adequate basis for its assessment, "all" will rarely be the correct requirement for the independent auditor.

Safeguarding of Assets

We believe that there will be a considerable number of implementation questions on the auditor's responsibility for identifying and testing controls related to the safeguarding of assets. We believe a mechanism, such as a PCAOB staff Q&A document, can help provide consistent and timely answers to questions about which controls should be included in the controls assessment and how they should be tested.

For example, in a retail operation, is the failure to use security cameras or merchandise theft tags a weakness? Does the auditor need to test or have a security expert test such controls if they are represented to be in use? Are poor pricing policies a control weakness? Is inefficiency a control weakness? Should controls be established to prevent the loss of customer lists and intellectual property and to what degree of security must these controls operate to be considered effective?

We believe this subject area can quickly mushroom into something unintended such that every business problem might be articulated in terms of it being evidence of an absence or failure of controls.

Additional Specific Comments

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1. Paragraph 2 should be modified to directly address benefit plans that file Form 11-K. The SEC staff has recently informally stated that such issuers are not subject to the reporting requirements of Section 404.

2. Paragraph 33 introduces a level of audit committee pre-approval for "internal control-related services" that appears to exceed the pre-approval requirements in the SEC rule, since they must be "specifically" pre-approved.

   The SEC set the requirements for the pre-approval of services after due process. In our view, if modifications of those requirements are considered necessary, we would expect those modifications to come from the SEC.

3. Paragraph 34 says internal control auditing requires more than ordinary attention to maintaining independence. This implies that auditors can give only "ordinary" attention in "ordinary" engagements, which presumably include audits of financial statements. We don't understand the rationale for this statement or what extraordinary measures the auditor needs to take. We also do not agree that this requires any more diligence regarding independence than other attest engagements.

4. Paragraph 57 – The fifth bullet refers to complying with listing standards. We do not understand the reason for this. First, not all issuers are subject to the listing standards (because not all are listed). Second, the listing standards deal with the composition and activities of the audit committee and thus only deal indirectly with reliable financial reporting.

5. Paragraph 94 focuses on timing from the standpoint of work at an interim date vs. work at the "as of" date. The final standard should also provide guidance on what to do when the auditor is hired after the "as of" date.

6. Paragraph 126 – The first sentence should say that the following "should *usually* be regarded …" There are often cases where a restatement of financial statements is not due to any weakness in internal control (e.g., cases where accounting or disclosure is responsibly reviewed at all levels of the company and at the highest levels of the auditing firm, but a restatement is still required due to the insistence of the SEC staff based upon differing judgment).

7. Paragraph 134 states: "the auditor should obtain evidence that internal control over financial reporting has operated effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the company's financial statements." We believe the term "sufficient" in this case is unclear. We assume the Board means that they must operate for a long enough time to allow for testing of their effectiveness (e.g., a few weeks or a month for frequent controls), and not over an extended time during the year.

8. Paragraph 156 says that when separate reports are issued on the audits of the internal control over financial reporting and the financial statements, an auditor needs to add to the report on the financial statements audit a reference to the audit of the internal control over financial reporting. Shouldn't the auditor also add a comment to the report on the internal control audit referring to the financial statements audit?

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9. Paragraph 173 seems to presume that management would disclose in its report on internal control over financial reporting a subsequent event that materially affects the effectiveness of the controls. We do not believe there is currently any specific SEC requirement for management to make such disclosure until the subsequent quarter, in which the change occurred. Therefore, we believe the PCAOB should clarify its view on management's disclosure requirement in the final standard. If the PCAOB believes that disclosure is implicitly required, the PCAOB should add a footnote or use some other means to fully explain the rationale for this conclusion. This will ensure that auditors and issuers focus on this point

10. Paragraph 181 presumes that reports on internal control are "part" of a registration statement and subject to Securities Act liability. We question whether this is the case, as such reports are required in Securities Act filings only when the issuer *elects* to use a short-form registration statement that requires the issuer to incorporate the most recent annual report by reference.

11. B15 states: "the evaluation ordinarily would not extend to controls at the equity method investee…" We cannot envision a circumstance where it should, and unless one can be identified we suggest the word "ordinarily" be struck.

* * * * *

We appreciate your consideration of our comments and suggestions, and would be pleased to communicate or meet with the PCAOB and its staff to clarify any of our comments.

Please direct comments to Wayne Kolins National Director of Assurance at 212-885-8595 Wkolins@bdo.com or Lynford Graham, National Director of Auditing at 212-885-8551 Lgraham@bdo.com.

Sincerely,

BDO Seidman, LLP

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November 21, 2003

VIA ELECTRONIC DELIVERY

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20069-2803

Re: PCAOB Rulemaking Docket Matter No. 008

Dear PCAOB Members:

Thank you for the opportunity to comment on the proposed rules contained in PCAOB Release No. 2003-017 (Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements).

BellSouth Corporation is a Fortune 100 communications services company headquartered in Atlanta, GA, serving more than 45 million customers in the United States and 14 other countries. With one of the largest shareholder bases in America, we have assets of almost $50 billion and employ approximately 77,000 individuals.

Overall, we express general support for the proposed auditing standard (the "Proposed Standard"). In addition, we support, and agree with, all of the issues addressed in the comment letter filed by the **American Society of Corporate Secretaries** earlier today. Specifically we are concerned about the following provisions of the Proposed Standard:

- Oversight of Effectiveness of Audit Committee. We believe that it would be inappropriate for the external auditor to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting, given that the audit committee is itself responsible for hiring the external auditor. Further, we believe that any additional benefit to be gained by requiring the external auditor to evaluate how audit committee members are nominated and selected would be marginal at best, and would be far outweighed by the time, costs and efforts that such an evaluation would require.

- Communications. We question the benefit of requiring the external auditor to communicate to audit committees when written communication to management regarding all deficiencies in internal control over financial reporting identified during the audit has been made. It seems likely that most audit committees will find it difficult to simply accept this information without requesting additional information about that communication, causing them to spend needless time on insignificant deficiencies.

- Reliance on Work of Others. We believe that the sections covering using the work of others are too restrictive and will lead to a duplication of work between internal auditors and external auditor. Further, the Proposed Standard is not conceptually consistent with the flexible risk-based approach in SAS No. 65. In addition, we believe the requirement that the auditor's own testing must provide the principle evidence for the auditor's opinion is subject to significant interpretation. We believe the Board should reconsider its approach with respect to the amount of reliance an auditor is able to place on the work of internal audit and management.

- Terminology. We strongly agree with ASCS that the Board's proposed definitions of "significant deficiency" and "material weakness" are unworkable. We request that the Board consider instead using definitions that depend on whether there is a reasonable possibility that individual or aggregated deficiencies would lead to a material adjustment in the financial statements, in the case of significant deficiencies, and on whether it is reasonably likely the deficiencies would lead to a material adjustment in the financial statements, in the case of material weaknesses.

- Qualified Attestation. We are extremely concerned that shareholders and the public will not understand situations in which a company receives an adverse opinion on the effectiveness of internal control over financial reporting due to a material weakness that did not result in a material misstatement in the financial statements. Therefore, we request that the external auditor be permitted to determine whether its opinion should be "qualified" rather than "adverse."

Respectfully submitted,

Raymond E. Winborne Jr.
Assistant Vice President - Controller

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November 8, 2003

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

Re: PCAOC Rulemaking Docket Matter No. 008

Ladies and Gentlemen:

As a former auditor and accounting standard setter, and as a present member of the audit committee of three large publicly held corporations, I read your exposure draft on auditing internal control with interest. Accounting firms, corporate managers, and others will comment in detail on what is a very comprehensive document. I wish to make just a few general observations and then comment on one specific provision of the draft.

General Concern About the Extensive Amount of Testing

In general, I support independent auditor involvement with and reporting on internal control. However, the current draft strikes me as “overkill,” requiring much more specific testing by the independent auditor than is necessary. In particular, my impression is that the draft allows insufficient reliance on the work of internal auditors. Frankly, I believe that internal auditors may be more experienced and better prepared to test some internal controls than external auditors. Another impression is that the independent auditors would have to do unnecessary, frequent re-testing of controls that haven’t changed from period to period.

The PCAOB needs to consider the benefits of a required audit of internal control vs. the incremental costs. Costs are relatively easy to measure, at least after the fact. I note that the Committee on Corporate Reporting of Financial Executives International estimates that audit fees likely will increase by 30-50% if the exposure draft is adopted without change. My reading of the draft and general familiarity with the present costs of audits leads me to believe that that range is a reasonable estimate.

What then will be the estimated benefits against which such actual costs should be compared? I have heard two principal arguments for mandating audits of internal control. First, that required audits of internal control will lead investors to place more confidence in financial reports, to counter concerns that such confidence has declined as a result of recent restatements and accounting frauds. And, second, that if we are able to prevent even a single Enron or WorldCom and the resulting loss to investors the money will be well spent. The former reason is hard to evaluate although it certainly seems reasonable. I'm particularly concerned, however, about the second reason.

As a member of the Special Investigative Committee of the Board of Directors of WorldCom, I saw (after the fact) the terrible financial reporting fraud, and I helped the company try to determine what happened and how to prevent reoccurrences. You can view the Special Investigative Committee's final report in the SEC Edgar system. On pages 223 through 263 of that report the Committee discussed the work of Arthur Andersen. Without going into great detail here, it is fair to state that Arthur Andersen had evaluated WorldCom's internal controls as being very strong, such that they could do limited substantive testing using a "controls based audit." I fully recognize that an accounting firm's evaluation of internal control for purposes of planning the audit is nowhere near the same as an audit of internal control. However, I submit that if Arthur Andersen could have been so off base with respect to the general quality of internal control under the "old rules," there is no assurance that they would have caught the problems under the "new rules."

PCAOB Board members obviously have to make a tough judgment as to how much detailed work must be mandated in an audit of internal control. But I make the above observations so you are clear that sloppy auditing or an extremely well designed fraud may still cause some frauds to be undetected. As one observer recently commented, is it necessary for all public companies to have to take chemotherapy because a few of them could develop cancer? I urge you to carefully consider the comments of others who make suggestions to reduce some of the excessive detail in the draft while maintaining the overall objective.

<u>Evaluation of the Audit Committee</u>

My specific comment deals with your questions 22 through 24. I think it would be a mistake to require independent auditors to evaluate the effectiveness of the audit committee and consider an ineffective committee to be a material weakness. First, I think such a requirement would create a direct conflict. Under Sarbanes-Oxley audit committees have to hire and fire independent auditors. The audit committees on which I serve have already adopted procedures for the committee to evaluate the performance of the auditors annually. And, as part of our very open discussions with the auditors, we seek their feedback on how the committee's performance might be enhanced. However, requiring the auditors to specifically evaluate the audit committee's effectiveness creates a situation where either party could, effectively, "vote the other party off the island." That could lead to a very wary relationship between the parties rather than the positive, open communications that are needed.

Second, I am concerned about how the independent auditors would determine what is or isn't "effective performance" by an audit committee. While the draft does provide some limited implementation guidance in paragraph 57, this would inevitably be a tough judgment call. (I suspect that the only time an accounting firm would conclude that an audit committee was ineffective was at the same time the firm had decided to resign from the engagement.) I am particularly concerned about the first sentence of paragraph 58 that says, "As part of evaluating the independence of committee members, the auditors should evaluate how audit committee members are nominated and selected <u>and whether they act independently from management</u> (emphasis added)." Ideally, the audit committee should work closely with both management and the external auditors. The language cited would suggest that each of these parties has separate interests, which shouldn't be the case.

Finally, do you really want to put accounting firms in the position of "validating" the performance of audit committees in the event of subsequent lawsuits resulting from accounting problems? Think of the Enron situation.

Assuming that Arthur Andersen had concluded that the Enron audit committee was operating in an effective manner, when problems later developed would that shield the audit committee from any responsibility and place all of the blame on the auditors?

It certainly makes sense for the independent auditors to consider the work of the audit committee as part of the overall control environment. However, specifically requiring an evaluation and, in particular, possibly considering the audit committee to represent a material weakness just doesn't make sense to me. Chairman McDonough noted in a recent speech to the National Association of Corporate Directors that this particular provision struck him initially as problematic although it grew on him as he thought more about it. I feel that his first impression was correct.

Other

As a final comment, I am concerned about the inclusion, in several places in the draft, of statements that the document only specifies minimum procedures and additional work may be necessary. (An example is paragraph 40 – "The auditor could also evaluate additional relevant factors when planning the audit of internal control over financial reporting.") Those statements could cause accounting firms to expand their detailed procedures even more for fear that the SEC, a court, or some other after-the-fact critic could challenge them. When I was in public accounting we referred to such language as "hanging words" – the verbiage that plaintiff attorneys would seize on to challenge even the most reasonable audit performance. Given that this document already calls for an extremely comprehensive amount of work by the independent auditors, I urge you to reconsider whether these catchall phrases are necessary.

Please note that these are my personal comments and should not be attributed to my university nor to any of the corporations on whose boards I sit. If you have any questions about my comments, please call me.

Sincerely,

Dennis R. Beresford
Ernst & Young Executive Professor of Accounting

From: silvio31@juno.com
Sent: Friday, November 21, 2003 2:20 PM
To: Comments
Subject: comments on #008

As a senior financial executive in a public company that is subject to the internal controls assessment and independent auditor opinion on our assessment I am deeply concerned with the direction that this rulemaking is going. Prior to joining my current employer I had the pleasure of working for two of the remaining four large public accounting firms.

I am impressed by many of the comments you have received thus far, especially by the fact that many of my peers and individual investors have pointed out several of the challenges facing businesses as we work in good faith to implement these rules.

The Profession Comes First

Having worked for many years in two of the largest public accounting firms as a financial auditor I am all to familiar with the efforts which were made by our national practice office and our local regional offices to ensure that our approaches, methodologies, pricing, and pay-scales were “closely aligned” with our competitors. We were taught to compete – but to never undercut our competitors. We were taught to try to attract talent from a competitor – but only in limited quantities so as to prevent their management from going to our management and raising “raiding” allegations. We were taught to never undermine or undercut our competition in the market place for fear that it would make the whole profession look bad.

Occasionally we had a renegade employee or partner who got a little too aggressive in the marketplace. Whenever this happened the regional director would call in the partner and his goals would be “re-prioritized.” Sometimes, these partners would be transferred to other positions or accounts. The partners were taught two primary principles: “never lose an account” and “never start a competitive turf war with one of the other major firms.”

Optics Are Everything

It was always clear that each firm offered essential the same solutions. It was not uncommon for us to receive “briefing sessions” from senior partners communicating how we should respond to particular issues that from time to time confronted the profession. These sessions usually were restricted to the partner ranks and included detailed “talking points” to make sure that we all communicated a consistent and positive message. During these sessions the views and opinions of the other firms were openly shared and discussed. More often then not it was clear that the position we were taking would be consistent with the position that our competitors took. For me this occurred during the Savings & Loan Crisis.

A Client’s View

Now, sitting on the other side of the table as a client, I see how destructive these incestuous relationship really are. When I ask my external audit partner and their competitor to share with me their perspective on a particular current event – the answer is always the same. There is no intellectual insight or value provided when these accounting-robots churn out their standard fast-food accounting checklists and policy directives. On the major issues the firms consistently provide a standard well-coordinated message.

Having been raised within the public accounting community it is fairly transparent to me that this is occurring. What is more surprising to me is the fact that the firms often ask their clients to assist in them in their endeavors to share information with one another. Our external auditor has asked us to secure competitive intelligence on their behalf as well as to share “confidential” information with key contacts at other firms. The intent is clear – to send a message, a signal, to their competition on where they area headed on a particular issue. Although they must have direct channels of communication at the top of these firms there is a significant amount of activity that occurs at lower levels in the firms.

Clandestine Partnerships?

Personally, I believe that this type of activity has increased significantly over the past few years. This is especially true in how consistent the message has become among the large firms in what they perceive as being required and how significant their role needs to be when we discuss Sarbanes-Oxley. Our external auditors have recommended to us that not only do they need to participate, to a significant degree, on the overall project steering committee but they have also suggested to us that one of their competitors is better qualified then another (non big four) competitor to assist us in our endeavors. They have obviously established a "teaming" relationship with the other large firm in our (geographic) area. They "highly recommend" that this particular competitor perform those services that they cannot perform for us (namely some of the testing activity). This seems odd – but one can only assume that their competitor provides them with a similar endorsement.

What is disturbing to is that in our situation, we had two additional competitive bids from other firms (one big four and one non-public accounting firm). The non-public accounting firm actually presented what we considered a very robust approach to Sarbanes-Oxley compliance. We felt they could provide significant value to our organization. Their approach was unique and absolutely different then the proposals we received from the other larger firms. They came to the table with a software solution to help us document controls. They had a better approach around some of our key business systems and were able to demonstrate some specific experience and skills in this area. And, they were significantly less expensive (by a magnitude of 35-40% less) then their big-four counterparts. Overall, we felt more comfortable with their approach and their people.

Using Audit Fees As a Hammer

Unfortunately, our external auditors advised us that if we used this firm they would likely have to re-perform many of the procedures. The net effect would be our total costs (using this third party) would be equal to or greater then the fees we would pay by using our external auditors "preferred partner." This caught our attention. It was made very clear to our management team: we either worked with our auditor to participate on the project and use their big-four counterpart or we risked having them come in and re-perform many of the same procedures that we proposed to do internally with the assistance of this other firm.

We have deferred our decision until your rules are finalized. But, we are very uncomfortable with where this is headed. It was made clear to our company at least that our external auditors would have the final say on how our project was organized. They arrogantly used the term "pay me now or pay me later" when speaking with our executive team.

Our CEO was so offended by that remark that he asked me to write this letter to you. He feels as if our external auditor has been put in a position of unbridled power. He is questioning how we can justify to our shareholders paying millions of dollars per year to comply with these requirements. He is devoted to meeting the letter and spirit of the law. However, we are increasingly irritated by what he perceives as unrelenting pressure by our auditors to incur costs needlessly and to incur costs for initiatives that provide no meaningful value to our shareholders. This brings me to our second point.

Repackaging Non-Audit Services

Our external auditors have brought a number of different teams of specialist to meet with us. Some to talk about our accounting systems, some to talk about our networks, some to talk about our tax structures, and finally some to talk about our consolidation system. In each situation the story is about the same. They would like to bring in their team of "specialists" to help us develop a business continuity plan, a state and local tax compliance program, an attack and penetration assessment of our network, or an improved financial close process using some new consolidation software.

In each of these situations the goal is to help us comply with Sarbanes-Oxley (404) and get some real business value (cost savings?) at the same time. The idea is interesting. Hire the specialist to help improve our business processes or risk points and achieve a positive return on our investment in Sarbanes compliance. Our auditors have proposed that by taking on these special "404-related" projects they could help us ease the "compliance burden" and get real value from our documentation initiative. The catch? In everyone of these discussions they refer to these projects as "audit related."

We have asked them to put their ideas into proposals that we can share with our audit committee who has to approve all projects where the external auditor is engaged to provide additional services. Our auditors have steadfastly refused these requests. They have hinted that in order to gain audit committee approval for these projects they need to be "audit related" and that they need to "protect" our audit committee by not suggesting (in a proposal or presentation) that these are anything but something related to the audit. They have pointed that we are allowed to engage them for audit related activity and that these 'special projects' should fall into that category of services.

Obviously we are fairly skeptical about this approach. Our Senior Management team has more integrity then that. My CEO has stated that he will have nothing to do with these types of dealings and that the tactics and principles of our auditors are absolutely unacceptable. He does not want us to enter into any agreement with out external auditor that is not fully and completely disclosed to our audit committee and board of directors. The suggestion and innuendo by our auditors is disconcerting to say the least. But they are not alone. We have had conversations with some of the other Big 4 firms and they have also indicated that they are often required to call things “audit related” when in fact they are clearly more then “audit related”. Some of my colleagues at other companies have expressed to me privately that they have these same sorts of discussions with their external auditors.

For this reason, we would believe that your rules should clearly state that the external auditor is prohibited from assisting in documentation of internal controls or any other service not directly related to the performance of a financial statement audit.

Subtle Threats

Our external auditors have placed us in an uncomfortable position. There is incredible pressure to do what they want to ensure that we secure a clean audit opinion. We have taken the internal position, with the support of our Board of Directors, that our external auditors should be completely barred from providing any service other then the audit itself. They should not be allowed to provide tax, information technology, internal audit, operational audit, or any other service to their audit clients.

We have communicated our Boards intent to our Coordinating Partner and several members of their team. We are trying to maintain a positive relationship with them and are reluctant to switch providers because we believe that these tactics are fairly uniform among the large firms. Any clarity you can provide in your rules to address these types of behaviors and to send a clear message to auditors that this type of behavior is unacceptable will be greatly appreciated. For the most part, we think we can meet the requirements and we would like the freedom to prove that we care about internal controls as much if not more then our external auditors.

Sincerely,

Silvio Berlusconi

November 21, 2003

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

RE: PCAOB Rulemaking Docket Matter No. 008

Dear Sir/Madam:

The undersigned wishes to comment on behalf of The Boeing Company (the "Company") on the Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements.* The Company supports the issuance of a new standard for auditing internal control; however, we wish to convey certain comments on the proposed standard, as set forth herein. Our comments pertain to the following general topics:

- Auditor professional judgment
- Definitions of "significant deficiency" and "material weakness"
- Audit Committee oversight
- Superseded controls

Auditor professional judgment

Existing auditing standards generally allow for broad application of auditor judgment. Despite certain audit failures that have occurred recently, the audit process overall has functioned effectively. We believe the new standard for audits of internal control over financial reporting should continue to allow the auditor to exercise judgment in designing audit tests and evaluating results. Related to the proposed standard, we have comments on the use of auditor judgment related to certain areas, including walkthroughs, use of the work of others, and evaluation of internal control deficiencies. In each situation indicated below, we believe incorporation of auditor judgment is necessary to produce results that are truly representative of the underlying circumstances.

Walkthroughs

The proposed standard requires the auditor to perform a walkthrough for all significant processes of a company. In question 10, the PCAOB asks whether it is appropriate to require that the walkthroughs be performed by the auditor himself, rather than allowing the auditor to use the walkthrough procedures performed by management, internal audit, or others. While we agree that walkthroughs provide evidence that supports the process flow of transactions, the design of controls and whether controls are in operation, we believe that it is neither practical nor necessary for the auditor to perform a walkthrough for *all* significant processes. The effort involved in complying with this aspect of the proposal, as written, would require a very large time commitment by company personnel and the auditor, and would result in unduly high audit fees. Rather than requiring the auditor to perform a walkthrough of each significant process, we suggest the auditor use professional judgment to determine which of the significant processes require an auditor-performed walkthrough to support the auditor's opinion.

In performing a walkthrough, the proposed standard states that the auditor should include *all types of transactions and events* that flow through a significant process. Because of the varying materiality and significance of different types of transactions, we believe that it is neither practical nor necessary for the auditor to include "all types of transactions and events" in a walkthrough of a process. Rather, we suggest that a walkthrough include a representative sample of transactions and events for the process, selected by the auditor using professional judgment.

Use of the work of others

The proposed standard requires the auditor to perform enough testing first-hand, that the auditor's original work provides the principal evidence for the auditor's opinion, hence subjecting the amount of reperformance of other parties' tests to auditor judgment. In question 15, the PCAOB asks whether the proposed flexibility in determining the extent of reperformance of the work of others is appropriate, or whether the auditor should be specifically required to reperform a certain level of work. We believe the proposed flexibility afforded to auditors is appropriate. Because the quality and extent of work performed by management, internal audit, and others varies depending on many factors, we believe a prescriptive approach would be inappropriate. Professional judgment should be relied upon to tailor the auditor's reperformance efforts based on the competence, objectivity, timing, and extent of the work of others. Likewise, we believe reperformance should not require duplication of each and every test performed by the initial party.

The proposed rule also specifies several areas in which the auditor shall not use the results of testing performed by others, including certain controls that are part of the control environment, controls over period-end financial reporting, information technology general controls, and walkthroughs. In question 12, the PCAOB asks to what extent the auditor should be permitted or required to use the work of others. We believe use of the work of others should be at the auditor's discretion, and should not be explicitly precluded in any circumstance. The auditor should be permitted to exercise professional judgment in determining the extent to which the auditor can incorporate the use of testing by others.

Evaluation of internal control deficiencies

The proposed rule indicates that the auditor must determine whether internal control deficiencies constitute significant deficiencies or material weaknesses. In question 19, the PCAOB asks whether it is necessary for the auditor to evaluate the severity of *all* identified internal control deficiencies. We believe such evaluation is necessary. The auditor should evaluate the significance of a deficiency in internal control by considering the likelihood and potential magnitude of a possible misstatement in the financial statements, using professional judgment.

In question 8, the PCAOB poses a similar question, asking whether inadequate documentation is an internal control deficiency, for which the auditor must assess the severity, or whether it should automatically be deemed a significant deficiency or material weakness. Our response is that inadequate documentation should not be prescriptively evaluated or automatically designated, but subjectively analyzed in the context of the entire internal control structure. In fact, we believe more broadly that none of the controls and circumstances listed in paragraphs 123 and 126 should be automatically designated as significant deficiencies or material weaknesses (or strong indicators thereof). We believe the auditor's professional judgment is required to appropriately analyze the specific circumstances surrounding the internal control deficiency.

Definitions of "significant deficiency" and "material weakness"

The proposed rules include new definitions for control deficiencies, including "significant deficiency" and "material weakness." In question 17, the PCAOB asks whether the new definitions of these terms will provide for increased consistency in the evaluation of deficiencies, and asks how the definitions can be improved. We believe the new definition for a significant deficiency requires further clarification as described below.

Current auditing literature defines the terms significant deficiency and material weakness as follows:

> *Significant deficiency / reportable condition (significant deficiency has same meaning as reportable condition, per the SEC):* a significant deficiency "in the design or operation of internal control 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."
>
> *Material weakness:* "a 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 may occur and not be detected within a timely period by employees in the normal course of performing their assigned duties."

The proposed rules define the terms significant deficiency and material weakness as follows:

> *Significant deficiency: "*a significant deficiency is an internal control deficiency that adversely affects the company's ability to initiate, record, process, or report financial data reliably in accordance with generally accepted accounting principles. 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."

Material weakness: "a material weakness is 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."

The proposed new definitions are written more prescriptively and narrowly than the existing definitions. The definition in the proposed standard of "significant deficiency" is comprised of two main components: 1) "more than a remote likelihood" of a misstatement, involving 2) an amount that is "more than inconsequential." We believe the first component referencing "more than a remote likelihood" is well understood by management and auditors, as the term "remote" is specifically indicated to have the same meaning as in SFAS No. 5. The term "remote" is broadly applicable and regularly used in certain other accounting assessments. By referring to the term "remote," we interpret that the PCAOB intends to clarify the previous use of the term "could" that is contained in the existing definition, and we support such clarification.

However, in the second component of the definition, the term "inconsequential" is not well understood. Further, the examples currently included in Appendix D do not elaborate on the meaning of this concept, except to indicate that the scenarios deemed significant deficiencies were not material. We believe the "more than inconsequential" threshold should be defined and explained more fully to reduce diversity in interpretation among management, the auditor, the audit committee, and any other interested parties.

Audit committee oversight

The proposed rule sets forth requirements for the auditor to evaluate the effectiveness of the audit committee as part of the control environment and monitoring components of a company's internal control over financial reporting, and includes specific factors related to audit committee effectiveness that the auditor should evaluate. We agree that the effectiveness of the audit committee is an important aspect of the control environment and monitoring components of a company's internal control over financial reporting. However, we suggest that the list of specific evaluation factors be omitted, and replaced by reliance on the guidance provided in the COSO framework. In describing the control environment, the COSO framework identifies the audit committee as playing an important role in establishing an effective "tone at the top" for an organization. The COSO framework also provides a list of specific matters related to the audit committee that might be considered in an evaluation of the control environment. We believe that the guidance in the COSO framework is sufficient.

Additionally, the proposed rule provides a list of circumstances that are automatically regarded as at least a significant deficiency (and possibly a material weakness). Ineffective oversight by the company's audit committee is included in that list. We believe the auditor's professional judgment is required in all cases to determine the severity of identified internal control deficiencies, and that no deficiencies, including ineffective oversight by the company's audit committee, should be automatically designated as significant deficiencies or material weaknesses (or strong indicators thereof).

Superseded controls

From time to time, companies implement changes to their controls. The proposed rule indicates that when such changes occur, the auditor may need to evaluate controls that have been superseded if the new controls have not been in effect for a sufficient period. Because management's assertion and the auditor's opinion are expressed as of a certain date, we believe the auditor should not be required to evaluate controls that were superseded and replaced before the date being reported on. We believe superseded controls are irrelevant to the reports of management and the auditor, as both are stated as of a particular point in time.

Finally, we wish to express our concern over the high potential costs to companies, and ultimately the investing public, to compensate the auditor for the extensive audit effort required to comply with the proposed regulations. Based on these proposed rules, we expect a sharp increase in audit fees, in addition to higher internal costs required to support management's internal control assessment. While we generally support the overall intent of the proposed auditing standard, we ask the PCAOB to focus on the cost-benefit relationship and impact of decisions made, being mindful of the value that will be gained for investors.

Sincerely,

James A. Bell
Senior Vice President of Finance & Corporate Controller

Boise Cascade Corporation
1111 West Jefferson Street PO Box 50 Boise, ID 83728

November 21, 2003

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street NW
Washington, DC 20006-2803

RE: PCAOB Rulemaking Docket No. 008

Dear Sir/Madam:

Boise Cascade Corporation (Boise) would like to take this opportunity to comment on your proposed auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (proposed standard). We thank the Public Company Accounting Oversight Board (PCAOB) for the opportunity to comment on this proposed important new standard.

Boise is a large international Fortune 500 company with major investments in paper manufacturing and distribution, building material manufacturing and distribution, and office supplies distribution. Boise commends the PCAOB for taking this significant step in improving corporate governance and the quality of financial reporting. Boise takes corporate governance very seriously and has established integrity as a key corporate value. However, we believe there are specific opportunities to reduce the significant cost to implement the proposed standard and, at the same time, improve the quality of controls and financial reporting.

Our specific comments and recommendations are as follows:

1) We believe the proposed standard does not allow the auditor to place appropriate reliance on the work of management and the internal auditor. To ensure compliance with The Sarbanes-Oxley Act, companies have established, or are establishing, extensive processes to document and evaluate key controls over financial reporting. A large part of this work is aimed at areas the proposed standard specifically prohibits reliance upon management (walkthroughs, control environment, general IT controls, fraud prevention and reporting, and financial reporting). We believe high quality control documentation and evaluation on the part of management should facilitate the work performed by both the internal and external audit functions. Additionally, we believe the external auditor should be able to place much more reliance on a competent and objective internal audit function. There should be no areas specifically prohibited from reliance. Reliance should be based upon risk assessment, objectivity, and competence.

2) We believe the proposed standard is too prescriptive and detailed. We believe all constituents, including the investing public, would be better served by a more principles-based approach with the scope driven by risk assessment, judgment, and analytical procedures. The proposed standard does not differentiate enough between well-controlled companies and poorly-controlled companies in the type of

reliance on management and required audit procedures. This could have the unintended consequence of punishing well-controlled companies with duplicative procedures and tests.

3) We believe the company's Board of Directors should be responsible for evaluating the effectiveness of the Audit Committee, not the external auditor as required by the proposed standard. The current requirement creates a significant conflict of interest as the Audit Committee is normally charged with oversight of the external auditor.

4) We believe the definition of significant deficiency should be changed and clarified. The current definition would require a large number of minor control issues to be reported (those that are not judged material but that are judged more than inconsequential) and would have the effect of losing the impact of reporting the most important issues.

5) We believe the external auditor should be allowed to use judgment in determining whether partial reliance on the results of testing from prior years is acceptable. In this area, the proposed standard does not appropriately recognize the importance of cumulative knowledge or the importance of risk assessment and judgment in setting scope.

6) We believe the external auditor should not be required to duplicate the work performed by management and internal audit in forming their opinion on internal controls. Instead, they should take into consideration the amount and quality of internal control documentation, evaluations, and testing performed.

7) We believe the "point-in-time" nature of the external audit opinion needs to be re-evaluated. The requirement of the proposed standard to ensure that the external auditors update their work as of the audit date will place a large burden on the external auditors and management to complete significant work after year-end. This may impact the quality of the audit work on the financial statements.

We appreciate this opportunity to comment on the proposed standard.

Ted Crumley
Senior Vice President and Chief Financial Officer

GWW/MJP/SC/pjt

bp

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19 November 2003

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Dear Sir or Madam,

BP plc appreciates the opportunity to comment on PCAOB Release No. 2003-017, Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements. We support the intent of the proposed standard and believe, overall, that providing users of the financial statements with both management's assessment of the effectiveness of internal control and an independent auditor's evaluation of that assessment will increase financial information quality, raise investor confidence and, in the long term, improve the efficiency of capital markets. We would, however, like to offer several comments relative to the draft standard which BP believes could lessen the impact of the standard on companies without reducing its effectiveness.

First, with regard to Question No. 7, it is useful that the Board has provided criteria that auditors should use to evaluate the adequacy of management's documentation. However, the list is narrowly prescriptive rather than a guide to the types of documentation that should be considered. Therefore, it is limiting of other potential documentation alternatives that may provide equal or greater support and understanding of internal controls.

On Questions No. 9 and 10, we believe that, while the objectives to be achieved through walkthroughs by the auditor as described in the proposed standard are laudable, walkthroughs of the extent implied will significantly increase cost with limited, if any, incremental value. We believe the scope of walkthroughs implied by the proposed standard is excessive relating both to the potential number of processes impacted and the level of detail within a process at which the walkthrough is performed. We believe that it is reasonable for the auditor to perform walkthroughs on a limited and test basis; however, consistent with our view on Question 12 below, it is also appropriate for the auditor to review and rely on walkthroughs performed by management and/or internal audit where the auditor is able to confirm the effectiveness of a company's processes.

19 November 2003

Public Company Accounting Oversight Board

Regarding Question 11, we believe it is both quite costly and unnecessary to require the auditor to obtain evidence of the effectiveness of controls each year independently. Annual cycling of detailed testing is a logical and practical alternative that we believe still provides the assurance intended by the proposed standard. If significant organizational, systems, or process changes have occurred during a period, the auditor should apply judgment to determine which would warrant expanded or off-cycle testing.

Regarding Question 12, as indicated above we believe the auditor should be permitted to use the work of management and others to a much greater degree than described in the proposed standard. The prescriptive list of areas where the auditor should not use or should limit the use of work performed by others is unnecessarily restrictive. We believe the auditor can develop an informed opinion on the effectiveness of internal controls based upon a combination of direct evaluation and review of internal control testing performed by others and that combination can and should vary depending upon the circumstances.

In regards to Question 17, we believe that the proposed standard may result in a level of precision and certainty that is both impracticable and unwarranted, resulting in a level of effort that is quite costly to businesses and, inevitably, to the capital markets themselves. Specifically, we are concerned with the proposed standard which defines a significant deficiency as "an internal control deficiency, or combination of deficiencies, that results in a more than remote likelihood that a misstatement of the annual or interim financial statements that is more than inconsequential in amount". We regard this definition as infeasible to implement, and would suggest a definition that considers both probability and magnitude, while not being so all encompassing that a significant deficiency loses its meaning and importance. Furthermore, we believe the combination of the concepts of "aggregation", "more than remote likelihood", and "more than inconsequential in amount", taken together, will result in a considerable level of detailed documentation and testing by the auditor (even when effective management processes are in place) and hence result in significant cost for little incremental benefit to either the company or its investors. While perhaps a matter of interpretation, the combined concepts also appear to result in a different level of confidence than the "reasonable assurance" principle also articulated in the proposed standard.

19 November 2003

Public Company Accounting Oversight Board

Lastly, we see inherent and irreconcilable difficulties in the concept introduced by the standard of the independent auditor evaluating the audit committee. This concept creates the potential for serious conflicts of interest when the independent auditor, who is retained by and whose compensation is determined by the audit committee, is required to evaluate its effectiveness. The audit committee is an important component of the overall control environment; however, we would suggest an alternative approach be considered whereby the auditor would perform a general assessment of the audit committee during the Control Environment review and only undertake a more detailed review if significant issues with the audit committee's processes are identified.

We appreciate your consideration of our comments.

Your sincerely,

I Macdonald

Iain Macdonald
Group Vice President &
Group Controller

BROWN-FORMAN

PHOEBE A. WOOD
EXECUTIVE VICE PRESIDENT,
CHIEF FINANCIAL OFFICER

November 19, 2003

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

Reference PCAOB Rulemaking Docket Matter No. 008

Dear Members of the Board:

Thank you for your invitation to comment on PCAOB Rulemaking Docket Matter No. 008. As the Chief Financial Officer of a large NYSE listed company, I strongly believe I can offer unique insights into specific issues in your proposed auditing standard.

In general, I believe that adoption of the recommendations outlined in your proposed standard would be of significant value in strengthening corporate governance and the audit process to enhance public trust in the integrity of financial reporting systems. However, I take strong exception to the direction you propose in Appendix A, paragraphs 79 and 80.

Paragraph 80 specifically states that the auditor walkthroughs should encompass "the entire process of initiating, recording, processing and reporting individual transactions." Paragraph 79 states that "the auditor should trace ***all*** types of transactions and events, both recurring and unusual, from origination through the company's information systems until they are reflected in the company's financial reports."

The amount of work required by this standard is unnecessary and unproductive. Within any significant process, such as the revenue cycle, there are many types of transactions and events, some more significant than others. It is my understanding and belief that the intent of Sarbanes-Oxley section 404 is to document and test the ***significant*** processes, transactions, and ***key*** controls that are relevant to the company's financial statements. Tracing and testing of all types of transactions and controls is overly burdensome and cost-prohibitive.

Sincerely,

Phoebe A. Wood

Phoebe A. Wood

BROWN SHOE

Brown Shoe Company, Inc.
8300 Maryland Avenue
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314.854.4000

November 18, 2003

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

Reference: PCAOB Rulemaking Docket Matter No. 008

Ladies/Gentlemen:

This letter is providing our comments to PCAOB Release No. 2003-017, "Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements", issued October 7, 2003. Generally speaking, we believe the proposed standard is over-reaching and will be unduly burdensome. We believe the cost to comply with the proposed standard will far outweigh any of its intended benefits.

Our specific comments below are numbered to coincide with the specific questions asked by the PCAOB in the summary document issued with the proposed standard.

Question #10:

Is it appropriate to require that the walkthrough be performed by the auditor himself or herself, rather than allowing the auditor to use the walkthrough procedures performed by management, internal auditors, or others?

Response:

We believe it should be permissible for auditors to rely on the walkthroughs performed and documented by internal auditors assuming the auditors have determined, in their professional judgment, the internal auditors are independent and qualified to properly perform and document such work.

The redundancy of effort, and cost, of this duplicate work is not productive. The auditor's should be allowed to use their judgment in evaluating where they can rely on internal auditors' work in this area and in which areas they should do such work themselves.

Question #12:

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

Response:
We believe the auditor should have the ability to make the judgment as to how much work performed by management or internal auditors they can use. This judgment would, of course, be based on the auditor's assessment of the quality of the internal auditors performing such work.

Question #13:

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

Response:
We do not believe auditors should be precluded from relying on work performed by internal auditors in the control environment. Quality, in-depth, and ongoing work done by internal auditors in key areas, such as systems controls and controls over the period-end financial reporting process, can be extremely time consuming to adequately perform and document. Reliance on such work can significantly enhance the efficiency of the audit of controls without compromising the evaluation and testing process.

Question #14:

Does the proposed standard give appropriate recognition to the work of internal auditors? If not, does the proposed standard place too much emphasis and preference on the work of internal auditors or not enough?

Response:
We believe the proposed standard does not give appropriate recognition to the work of qualified and independent internal auditors. Once again, the duplicate effort and additional cost of have two qualified groups of auditors performing the same work is unnecessary.

Question #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?

Response:
We do not believe this should be a hard and fast rule that automatically precludes the use of internal audit work to effectively a prescribed extent. The auditor should be able to judge the extent to which they can rely on internal audit work, and which areas they need to perform work themselves.

Question #22:

Is it appropriate to require the auditors to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting?

BROWN SHOE

Response:

No. The auditors report to the Audit Committee; they should not evaluate the Committee.

Question #23:

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

Response:

We believe state law, the Federal securities law, the rules and regulations of the SEC and the NYSE more than adequately govern the role of the audit committee. It is the responsibility of the Board of Directors and counsel to the Board of Directors to assure that the audit committee is properly fulfilling its role and responsibilities. We do not believe requiring the auditors to evaluate the audit committee is an appropriate responsibility and is an unnecessary burden to place upon the auditors. In addition, without specific guidelines, or measurable criteria, specifically defining what qualifies as adequate, or appropriate, oversight of a company's external financial reporting and controls over such reporting, the auditor is in uncharted waters and could lead to wide variations in practice and application.

We recognize and support the need for strong internal controls over financial reporting and realize compliance with Section 404(a) of the Sarbanes-Oxley Act of 2002 is a major undertaking in terms of time, effort and money. At the same time, we believe that since the responsibility for compliance falls to the company, auditors should be able to rely upon the work already done by the internal auditors to the extent they are comfortable in doing so after performing the prescribed assessments. If the proposed standard is issued as it has been drafted, we believe a great deal of redundancy in time and effort will be required and the costs of audits will increase significantly, if not exponentially – without any proven additional benefit to investors. From a practical standpoint, we also wonder where the major auditing firms will find the number of experienced and trained auditors to perform this additional work.

We appreciate the opportunity to respond to the proposed standard and respectively request that Board consider our comments.

Sincerely,

Richard C. Schumacher
Senior Vice President and Chief Accounting Officer

Andrew M. Rosen
Senior Vice President, Chief Financial Officer
and Treasurer

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BY EMAIL

November 26, 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 (Proposed Auditing Standard – An Audit Of Internal Control Over Financial Reporting Performed In Conjunction With An Audit Of Financial Statements)***

Ladies and Gentlemen:

The following comments are submitted on behalf of the Business Roundtable, an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees in the United States and $3.7 trillion in annual revenues. The Business Roundtable strongly supported enactment of the Sarbanes-Oxley Act of 2002 (the "S-O Act"), and we support the efforts of the Public Company Accounting Oversight Board (the "Board") to implement the S-O Act. We appreciate the opportunity to provide you with our views on the Board's recent proposed auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* (the "Proposed Standard").

Scope of the Proposed Standard

Under Section 404 of the S-O Act ("Section 404"), management is required to prepare an internal control report that, among other things, is to include an assessment of the effectiveness of the internal control over financial reporting for the issuer. Section 404 separately requires a registered public accounting firm to "attest to, and report on, the assessment made by management of the issuer." Although the statute envisions a discrete responsibility for the auditor under Section 404 – attesting to, and reporting on, management's internal control assessment – the Proposed Standard appears to expand the scope of the auditor's responsibility beyond that contemplated under Section 404. By proposing at the outset that the auditor's attestation required under Section 404 be characterized as "an integrated audit of the financial statements and internal control over financial reporting," we believe that the Proposed Standard proceeds from an incorrect premise.

To fulfill Congress's mandate under Section 404, an auditor clearly needs to perform sufficient attest procedures to reach a conclusion regarding management's own assessment and evaluation of the issuer's internal control over financial reporting. These attest procedures need to be robust and aligned with the scope of the auditor's responsibility under Section 404. However, by proposing that the auditor conduct an audit of the internal control over financial reporting, the Proposed Standard embraces a level of testing that is more extensive than that contemplated under the statute. If Congress had intended the auditor to conduct a full-blown audit of an issuer's internal control over financial reporting, it would have expressed such intent by using the term "audit" rather than "attest," and it would have made clear that the scope of such "audit" extended to the entirety of the issuer's internal control over financial reporting and not just management's assessment of this function. Accordingly, we urge the Board to revisit the scope of the Proposed Standard.

In addition to our concerns around the scope of the standard, we believe that the standard as currently drafted, does not permit an auditor enough latitude to exercise its judgment with respect to what is an appropriate level of testing for the specific company. In companies that have strong control environments, routine transactional processing should only require a minimal amount of detailed testing of the controls. Further, the amount of detailed testing should vary by not only the type of transaction stream, but also by the auditor's judgment as to the risk of a material weakness or significant deficiency based on the control environment, including external factors. For example, the payroll cycle would have regular checks by employees and tax regulators, and therefore, an auditor might deem most of the risk to come from unauthorized people being paid and focus detailed testing on that area. In addition, we believe that auditors should be permitted to vary the level of testing from year to year based upon whether there have been changes in the documented controls.

Finally, we believe that a standard that more appropriately focuses on the significant issues around business risk, fraud prevention and detection would better serve the needs of investors rather than the very prescriptive detailed testing approach in the Proposed Standard.

Using the Work of Management and Others

The Proposed Standard sets forth several principles that limit the ability of the auditor to rely on the work of management and others in conducting the required attestation. Specifically, the Board proposes to prohibit reliance on the work of management and others when the internal controls at issue relate to the prevention or detection of fraud that is reasonably likely to have a material effect on the issuer's financial statements and to restrict reliance where the internal controls relate to non-routine transactions. Reliance is essentially only unfettered where the controls relate to routine processing. In addition, the proposal requires that the auditor's own work, on an overall basis, form the basis for the required attestation.

These proposed restrictions may have been suitable if the proposal were being adopted as a stand-alone effort to enhance internal control over financial reporting, but it is not. The S-O Act and the rules adopted by the U.S. Securities and Exchange Commission (the "SEC") to implement Section 404 already bolster the internal control over financial reporting function. Under Section 404, management is required to design and evaluate the effectiveness of the internal control over financial reporting, to prepare an annual report evaluating this function, and to certify as to the effectiveness of these internal controls. Our members and their financial and accounting teams take these new obligations very seriously. The proposed restrictions on the auditor's ability to rely on the work of management and others give insufficient credit to the significant steps that issuers are taking to comply with the Section 404 requirements.

Rather, the Proposed Standard would require auditors to develop and obtain separate and extensive evidence about whether the internal controls are effective. Consistent with the statutory requirement that the auditor attest to management's evaluation of these controls, the auditor should be able to exercise its judgment in deciding whether to rely on management's or others work with respect to the entire range of internal controls, not simply controls for routine processes. This approach will eliminate duplicative, unnecessary testing that would increase issuers' costs significantly with only questionable benefit, if any, for investors.

The final standard also should reflect attestation procedures that allow auditors to place greater reliance on testing performed by internal auditors. The internal audit function is set up to serve as a separate check on the financial reporting process in addition to the work performed by the external auditor. Yet, the Proposed Standard subjects the work performed by internal audit to the same proposed guidelines for reliance to which others within an issuer organization would be subjected. The final standard should allow an auditor to place greater reliance on work performed by internal audit where the outside auditor views the internal auditor to be sufficiently independent and competent.

Accordingly, the final standard should allow the auditor greater flexibility in determining whether to place reliance on the work performed by management and others within the issuer, including, in particular, the internal audit function.

Evaluation of the Effectiveness of the Audit Committee

The Proposed Standard provides that the auditor should evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting as part of its attestation requirements. The Board proposes that this evaluation should include, among other things, review of the audit committee's independence from management, compliance with applicable listing standards, and the level of involvement and interaction with the auditor (including the committee's role in appointing, retaining and compensating the independent auditor).

We believe that this proposed requirement is particularly inappropriate given the audit committee's direct responsibility for the appointment, compensation, retention and oversight of the registered public accounting firm under Section 301 of the S-O Act and implementing SEC and securities markets rules and listing standards. By creating a dual evaluation standard for the auditor and audit committee, the proposal would establish a clear conflict of interest. Moreover, the audit committee has responsibilities that go well beyond those in which it interacts with the external auditor, and the auditor does not have any particular expertise with respect to such issues as the independence of individual audit committee members from management. Accordingly, we believe that this aspect of the proposal is ill-conceived, and we urge the Board to eliminate it.

Definitional Issues

We have additional concerns about certain of the definitional aspects of the Proposed Standard. First, the Board proposes a "more than remote likelihood" standard to evaluate whether a deficiency rises to the level of a "significant deficiency" and whether a significant deficiency rises to the level of a "material weakness." This proposed standard creates an unreasonably low threshold for placing a purported deficiency into the "significant deficiency" category and for placing a purported "significant deficiency" into the "material weakness" category. We believe the current standard for determining whether the control component reduces to "a relatively low level" the risk of misstatement is more appropriate for each of these definitions, and we urge the Board to adopt this standard.

Second, the definition of "significant deficiency" also includes the concept that the deficiency at issue must be one that results in an inability to prevent or detect fraud that results in a misstatement that is more than "inconsequential in amount." It is unclear what this phrase is intended to mean; more than "inconsequential in amount" could mean relatively de minimis amounts to any given issuer. This construction could lead to the reporting of deficiencies that are by no means material, simply because they represent a perceived, consequential dollar amount. We therefore also urge the Board to replace this vague construction with a "materiality" concept, which has a more familiar and developed meaning under the securities laws.

* * *

We appreciate your consideration of these comments, and we would be happy to discuss these matters further or to meet with you if it would be helpful.

Sincerely,

David L. Shedlarz
Executive Vice President & CFO
Pfizer Inc.
Chairman-Principle Financial Officers Subcommittee
Corporate Governance Coordinating Committee
Business Roundtable

cc: William J. McDonough, Chairman
Kayla J. Gillan, Member
Daniel L. Goelzer, Member
William Gradison, Member
Charles D. Niemeier, Member

CalPERS

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November 21, 2003

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

Office of the Secretary: Re: Rulemaking Docket Matter 008

I am writing to you on behalf of the California Public Employees' Retirement System (CalPERS). CalPERS is the largest public pension system in the U.S., with approximately $148 billion in assets. We manage the retirement benefits and health insurance on behalf of nearly 1.4 million members.

CalPERS is very supportive of the PCAOB efforts to improve standards of financial reporting by publicly-traded companies and to improve standards of auditing those financial statements. CalPERS appreciates the opportunity to comment on the Proposed Auditing Standard – An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements. CalPERS expresses general support of the objectives of the Proposed Auditing Standard.

In addition, CalPERS would like to offer the following comments on some of the specifics of the Proposed Auditing Standard which is pursuant to Section 404(b) as well as Section 103(a)(2)(A) of the Sarbanes-Oxley Act of 2002.

1. <u>Management Assessment of Internal Controls.</u> Section 404(b) of Sarbanes-Oxley requires that "each registered public accounting firm that prepares or issues the audit report for each issuer shall attest to, and report on, the assessment {of internal controls} made by management of the issuer." The intent seems to be that management should make the assessment and the audit firm shall then gather sufficient competent evidence to attest to the validity, degree of validity, or non-validity of the assertion. We believe that the opinion on management's internal control assessment should have a graded scale rather than simply pass or fail. Implicit in this section of Sarbanes-Oxley is that the auditors will not be auditing their own work in preparing their opinion.

As a best practice for corporate governance, CalPERS believes that the Audit Committee should be involved in setting internal control policies and that management should execute these policies. We believe that part of the rationale in having management prepare the assessment is to encourage management to continually be involved in the internal control structure, procedures and evaluation, and to take ownership of the assessment. This serves to keep management informed of and contributing to improvements in the internal control structure, which is essential to the success of the internal control structure.

The proposed standard raises the question of reliance on the work of management and "others" by the external auditors. We will address this question by first discussing reliance on the work of management, then the internal auditors, and finally address the question of reliance on work of the remaining "others."

Work of Management; the external auditors should not simply rely on the work of management, but should review the process by which the assessment was obtained, and re-perform and test the assessment *as necessary*. Nevertheless, we agree an integrated audit of internal control and financial statements is necessary. However, reliance on the work of Internal Auditors should assist the external auditor in formulating an opinion. (Question 1-3, 6 of the Proposed Auditing Standards) *(*AICPA's Statements on Standards, AT Section 501.13 – Components of an Entity's Internal Control and Section 501.14-.15 Limitations of an Entity's Internal Control)

Reliance on Work of Internal Auditors. An important responsibility of the internal auditors is to continually evaluate, test and monitor internal controls of an entity. Therefore, the external auditors would determine if the Chief Internal Audit Executive is organizationally independent and review the qualifications of the internal auditors and the quality of their work so that they can determine the degree of reliance on the work of the internal auditors. The International *Standards for the Professional Practice of Internal Auditin*g provides the framework for independence and objectivity and competence of work performed by internal auditors. Ideally, the Chief Audit Executive should report functionally to the Audit Committee and administratively to the Chief Executive Officer. We also believe that the relationships of the Audit Committee, the External Financial Statement Auditor, other External Auditors, and the Internal Auditors are well outlined in the Example Audit Committee Charter endorsed by the Association of Public Pension Fund Auditors (APPFA). This Example Audit Committee Charter is available on their web site (www.appfa.org) in the References and Links section, and is enclosed as an attachment. (Also, guidance in AU Section 322, The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements provides direction to the external auditors in assessing the competence and objectivity of internal auditors.)

Reliance on Outsourced Internal Audit Work – Potential Conflicts of Interest. Previously, we commented on the independence of and qualifications of internal auditors as factors that the external financial statement auditor should evaluate when determining whether or not they could rely on the work of the internal auditors. We believe a potential conflict of interest would occur if internal audit work is totally outsourced to another CPA firm. Because of mergers and restructuring there are few audit firms that are the dominant members of the AICPA in which these firms would be evaluating each others work. This situation has the same potential problems that occurred when the AICPA members performed the PEER reviews of each other and did not find any substantial problems. Consequently, it would be counter-productive to create a similar situation with respect to the relationship between the external financial statement auditor and the outsourced internal audit function.

Reliance on the Work of the Remaining "Others." Reliance on the work of the remaining "others" should be up to the discretion of the External Financial Statement Auditor. They should use the same criteria as when determining whether or not to rely on the work of internal auditors. These criteria are independence, qualifications, competence and the quality of the work.

In conclusion, CalPERS believes that the external audit firm should first review the process by which management arrived at its assessment of internal control, and then look directly at and test the company's internal control as required in order to gather sufficient competent evidence for forming an attestation opinion on management's assessment of the internal control structure. The external financial statement auditors may rely on the work of internal auditors and others as described above. (Questions 4-5, 9-16 of the Proposed Auditing Standard)

2. <u>Evaluation of the Audit Committee's Role in Internal Control.</u> The question of who should evaluate the Audit Committee's role in internal control deserves careful attention. Ideally, this evaluation should be performed by experts who are independent of the Audit Committee and independent of the company. Since the external audit firm is hired by the Audit Committee, the external audit firm cannot be independent of the Audit Committee. Therefore, we believe that the full Board should hire specialists from a different firm to perform this evaluation. We suggest that an optimal solution is to seek this evaluation from a firm that is not a CPA firm and is free from this potential source of conflicts of interest. This will allow the CPA firms to concentrate their core business of audit and attestation work, and to be in a position to review and evaluate the work performed by others without potential conflicts of interest.

   In the event that the External Financial Statement Auditor determines that there is an internal control weakness with regard to the Audit Committee, then this should be reported in writing to the full Board. The full Board is then responsible for investigating and correcting the deficiencies. In addition, the external auditor should consider the facts in rendering their opinions on the internal control assessment by management and their opinion on the financial statements. (Questions 22-24 of the Proposed Auditing Standard)

3. Experience Levels of Audit Staff. CalPERS believes that the PCAOB should define the minimum experience levels expected of various levels of audit staff. In addition, we believe that companies should formulate their own contracts with the audit firms so they can add experience requirements beyond the PCAOB minimum. Contract terms should include minimum qualifications and specifications of experience for the audit firm, key personnel, and audit staff. These terms should include the right to approve changes in key personnel. (Question 5 of the Proposed Auditing Standard)

Although, we do not directly respond to all 31 questions we believe our comments provides the PCAOB an overview of CalPERS' response.

In summary, CalPERS reiterates its appreciation of the work that the PCAOB is performing and the opportunity to participate in the process. CalPERS believes that this work is essential for the integrity of the financial markets, and CalPERS looks forward to continual interchange of information and ideas with the PCAOB. If you have any questions regarding our comments on the two proposed rules, please contact Ted White, Director of Corporate Governance, at (916) 341-2731, or Larry Jensen, Chief of the Office of Audit Services, at (916) 795-0802.

Sincerely,

Mark Anson
Chief Investment Officer

Attachment: Audit Committee Charter – Endorsed by the Association of Public Pension Fund Auditors (APPFA)

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November 21, 2003

Office of the Secretary
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Office of the Secretary: Re: Rulemaking Docket Matter 008

We would like to elaborate on our comment # 2, Evaluation of the Audit Committee's Role in Internal Control, in our prior correspondence dated November 21, 2003. In our prior letter we questioned whether the external audit firm can perform an independent review of the Audit Committee. We believe that a *potential* conflict of interest arises if the external audit firm reviews the role of the Audit Committee in internal control. However, we would look to the PCAOB to determine whether a conflict *in fact* has occurred, and we would further look to the PCAOB to exercise its authority to enforce the independence of the external audit firm with respect to a review of the Audit Committee.

Again, CalPERS wishes to express its continued support of the PCAOB in its efforts to improve the standards of financial reporting by publicly-owned companies and the standards of auditing by external audit firms. We appreciate the opportunity to participate in the process of enhancing the financial integrity of our financial markets.

Sincerely,

Mark Anson

Mark Anson
Chief Investment Officer

Example Audit Committee Charter

Endorsed by the Association of Public Pension Fund Auditors (APPFA)

The following Example Audit Committee Charter captures many of the best practices used at the present time, July of 2003. Of course, no example charter encompasses all activities that might be appropriate to a particular audit committee, nor will all activities identified in an example charter be relevant to every committee. Accordingly, this example charter may be tailored to each committee's needs and governing rules. Moreover, as applicable laws, rules and customs change, the audit committee charter should be updated.

Endorsement by the Association of Public Pension Fund Auditors (APPFA) means that this document is intended as a starting point of reference and as a guide to public pension systems in formulating and/or revising their own charters. To the extent that a public pension fund has unique circumstances, different applications and modifications of the example passages may be desirable.

Audit Committee Charter

PURPOSE

The purpose of this "Example Audit Committee Charter" is to assist the Board of Directors in fulfilling its fiduciary oversight responsibilities for the**:**

(1) Financial Reporting Process,
(2) System of Risk Management,
(3) System of Internal Control,
(4) Internal Audit Process,
(5) External Audit of the Financial Statements,
(6) Engagements with Other External Audit Firms,
(7) Organization's Processes for Monitoring Compliance with Laws and Regulations and the Ethics Policy, Code of Conduct and Fraud Policy,
(8) Special Investigations and Whistleblower Mechanism, and
(9) Audit Committee Management and Reporting Responsibilities.

AUTHORITY

The audit committee has authority to conduct or authorize investigations into any matters within its scope of responsibility. It is empowered to perform the following functions, which are numbered according the purposes listed above:

(1) Financial Reporting Process

- Oversee the reporting of all financial information.

- Resolve any disagreements between management, the external auditor and/or the internal auditor regarding financial reporting.

Example Audit Committee Charter

(2) System of Risk Management

- Provide the policy and framework for an effective system of risk management, and provide the mechanisms for periodic assessment of the system of risk management, including risks of the information systems, and risks of business relationships with significant vendors and consultants.

- Oversee all consultants and experts that make recommendations concerning the risk management structure and internal control structure.

(3) System of Internal Control

- Provide the policy and framework for an effective system of internal controls, and provide the mechanisms for periodic assessment of the system of internal controls, including information systems, and internal control over purchases from significant vendors and consultants.

- Ensure that contracts with external service providers contain appropriate record-keeping and audit language.

- Seek any information it requires from employees-all of whom are directed to cooperate with the committee's requests, or the requests of internal or external parties working for the audit committee. These parties include the internal auditors, all external auditors, consultants, investigators and any other specialists working for the audit committee.

(4) Internal Audit Process

- Appoint, compensate, and oversee the work of the Chief Audit Executive and oversee the work of the internal audit unit.

- Serve as the primary liaison and provide the appropriate forum for handling all matters related to audits, examinations, investigations or inquiries of the State Auditor and other appropriate State or Federal agencies.

(5) External Audit of the Financial Statements

- Appoint, compensate, and oversee the work of the certified public accounting firm employed by the organization to audit the financial statements.

- Pre-approve all auditing, other attest and non-audit services performed by the external financial statement audit firm.

(6) Engagements with Other External Audit Firms

- Appoint, compensate, and oversee the work of any other certified public accounting firm employed by the organization to perform any audits or agreed-upon-procedures other than the audit of the financial statements.

(7) Organization's Processes for Monitoring Compliance with Laws and Regulations and the Ethics Policy, Code of Conduct and Fraud Policy

- Provide the policy and framework for compliance with laws and regulations, and provide the mechanisms for periodic assessment of compliance, including compliance by significant vendors and consultants.

- Communicate with the Board regarding the organization's policy on ethics, code of conduct and fraud policy as it relates to internal control, financial reporting and all auditing activities.

Example Audit Committee Charter

(8) Special Investigations and Whistleblower Mechanism

- Retain independent counsel, accountants, or other specialists to advise the committee or assist in the conduct of an investigation.

- Ensure creation of and maintenance of an appropriate whistleblower mechanism for reporting of financial statement fraud and other fraud and inappropriate activities.

(9) Audit Committee Management and Reporting Responsibilities

- Receive and review reports on all public disclosures related to the purpose, authority and responsibilities of the Audit Committee. Consider having a Disclosure Subcommittee for this purpose.

- Report to the Board on the activities, findings and recommendations of the Audit Committee.

(1 – 9) Comprehensive Communication Responsibility

- Meet with the organization's officers, external auditors, internal auditors, outside counsel and/or specialists, as necessary.

COMPOSITION

The audit committee will consist of at least three and no more than seven members of the Board of Directors. The Board or its nominating committee will appoint committee members and the committee chair.

Each committee member will be both independent and financially literate. At least one member shall be designated as the "financial expert," as defined by applicable legislation and regulation.

MEETINGS

The committee will meet at least four times a year, with authority to convene additional meetings, as circumstances require. All committee members are expected to attend each meeting, in person or via tele- or video-conference. Meeting notices will be provided to interested parties in conformance with applicable laws, regulations, customs and practices. The committee will invite members of management, external auditors, internal auditors and/or others to attend meetings and provide pertinent information, as necessary. It will hold private meetings with auditors {Subject to open meeting laws} and executive sessions as provided by law. Meeting agendas will be prepared and provided in advance to members, along with appropriate briefing materials. Minutes will be prepared.

Example Audit Committee Charter

RESPONSIBILITIES

The committee will carry out the following responsibilities:

(1) Financial Reporting Process

- Obtain information and training to enhance the committee members' expertise in financial reporting standards and processes so that the committee may adequately oversee financial reporting.

- Review significant accounting and reporting issues, including complex or unusual transactions and highly judgmental areas, and recent professional and regulatory pronouncements, and understand their impact on the financial statements.

- Review with management, the external auditors, and the internal auditors the results of the audit, including any difficulties encountered.

- Review all significant adjustments proposed by the external financial statement auditor and by the internal auditor.

- Review all significant suggestions for improved financial reporting made by the external financial statement auditor and by the internal auditor.

- Review with the General Counsel the status of legal matters that may have an effect on the financial statements.

- Review the annual financial statements, and consider whether they are complete, consistent with information known to committee members, and reflect appropriate accounting principles.

- Review other sections of the annual report and related regulatory filings before release and consider the accuracy and completeness of the information.

- Review with management and the external auditors all matters required to be communicated to the committee under generally accepted auditing *Standards.*

- Understand how management develops interim financial information, and the nature and extent of internal and external auditor involvement.

- Review interim financial reports with management and the external auditors before filing with regulators, and consider whether they are complete and consistent with the information known to committee members.

- Review the statement of management responsibility for and the assessment of the effectiveness of the internal control structure and procedures of the organization for financial reporting. Review the attestation on this management assertion by the financial statement auditor as part of the financial statement audit engagement.

Example Audit Committee Charter

(2) System of Risk Management

- Obtain information about, training in and an understanding of risk management in order to acquire the knowledge necessary to adequately oversee the risk management process.
- Ensure that the organization has a comprehensive policy on risk management.
- Consider the effectiveness of the organization's risk management system, including risks of information technology systems.
- Consider the risks of business relationships with significant vendors and consultants.
- Reviews management's reports on management's self-assessment of risks and the mitigations of these risks.
- Understand the scope of internal auditor's and external auditor's review of risk management over financial reporting.
- Understand the scope of internal auditor's review of risk management over all other processes, and obtain reports on significant findings and recommendations, together with management's responses.
- Understand the scope of any other external auditor's or consultant's review of risk management.
- Hire outside experts and consultants in risk management as necessary.

(3) System of Internal Control

- Obtain information about, training in and an understanding of internal control in order to acquire the knowledge necessary to adequately oversee the internal control process.
- Ensure that the organization has a comprehensive policy on internal control and compliance.
- Review periodically the policy on ethics, code of conduct and fraud policy.
- Consider the effectiveness of the organization's internal control system, including information technology security and control.
- Consider any internal controls required because of business relationships with significant vendors and consultants.
- Understand the scope of internal auditor's and external auditor's review of internal control over financial reporting, and obtain reports on significant findings and recommendations, together with management's responses.
- Understand the scope of internal auditor's review of internal control over all other processes, and obtain reports on significant findings and recommendations, together with management's responses.
- Review the role of the internal auditor's involvement in the corporate governance process, including corporate governance documentation and training.
- Ensure that contracts with external service providers contain appropriate record-keeping and audit language.
- Direct employees to cooperate with the committee's requests, or the requests of internal or external parties working for the audit committee. These parties include the internal auditors, all external auditors, consultants, investigators and any other specialists working for the audit committee.

Example Audit Committee Charter

(4) Internal Audit Process

- Obtain the information and training needed to enhance the committee members' understanding of the role of internal audits so that the committee may adequately oversee the internal audit function.
- Oversee the selection process for the chief audit executive.
- Assure and maintain, through the organizational structure of the organization and by other means, the independence of the internal audit process.
- Ensure that internal auditors have access to all documents, information and systems in the organization.
- Ensure there are no unjustified restrictions or limitations placed on the Chief Audit Executive and internal audit staff.
- Review with management and the Chief Audit Executive the charter, objectives, plans, activities, staffing, budget, qualifications, and organizational structure of the internal audit function.
- Receive and review all internal audit reports and management letters.
- Review the responsiveness and timeliness of management's follow-up activities pertaining to any reported findings and recommendations.
- Receive periodic notices of advisory and consulting activities by internal auditors.
- Review and concur in the appointment, replacement, or dismissal of the Chief Audit Executive, if allowed by state law.
- Review the performance of the Chief Audit Executive periodically.
- Review the effectiveness of the internal audit function, including compliance with The Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing.*
- On a regular basis, meet separately with the Chief Audit Executive to discuss any matters that the committee or internal audit believes should be discussed privately {Subject to open meeting laws}.
- Delegate to the Chief Audit Executive the management of the contract for the external financial statement auditor, and the management of the contracts for any other certified public accountants.
- Designate the Chief Audit Executive as the primary point of contact for handling all matters related to audits, examinations, investigations or inquiries of the State Auditor and other appropriate State or Federal agencies.

Example Audit Committee Charter

(5) External Audit of the Financial Statements

- Obtain the information and training needed to enhance the committee members' understanding of the purpose of the financial statements audit and the role of external financial statement auditor so that the committee may adequately oversee the financial statement audit function.

- Review the external auditor's proposed audit scope and approach, including coordination of audit effort with internal audit.

- Review the performance of the external financial statement audit firm, and exercise final approval on the request for proposal for, and the appointment, retention or discharge of the audit firm. Obtain input from the Chief Audit Executive, management and other parties as appropriate.

- Define the services that the external financial statement auditor is allowed to perform and the services that are prohibited.

- Pre-approve all services to be performed by the external financial statement auditor.

- Review the independence of the external financial statement audit firm by obtaining statements from the auditors on relationships between the audit firm and the organization, including any non-audit services, and discussing these relationships with the audit firm. Obtain from management a listing of all services provided by the external audit firm. Obtain information from the Chief Audit Executive and other sources as necessary.

- Review and approve the audited financial statements, associated management letter, attestation on the effectiveness of the internal control structure and procedures for financial reporting, other required auditor communications, and all other auditor reports and communications relating to the financial statements.

- Review and approve all other reports and communications made by the external financial statement auditor.

- Review the responsiveness and timeliness of management's follow-up activities pertaining to any reported findings and recommendations.

- On a regular basis, meet separately with the external financial statement audit firm to discuss any matters that the committee or auditors believe should be discussed privately {Subject to open meeting laws}.

- Provide guidelines and mechanisms so that no member of the audit committee or organization staff shall improperly influence the auditors or the firm engaged to perform audit services.

- Ensure production of a report of all costs of and payments to the external financial statement auditor. The listing should separately disclose the costs of the financial statement audit, other attest projects, agreed-upon-procedures and any non-audit services provided.

Example Audit Committee Charter

(6) Engagements with Other External Audit Firms

- Obtain the information and training needed to enhance the committee members' understanding of the role of the other external audit firm(s) so that the committee may adequately oversee their function(s).

- Review the other external audit firm's (firms') proposed audit or agreed-upon-procedures scope and approach, including coordination of effort with internal audit.

- Review the performance of the other external audit firm(s), and exercise final approval on the request for proposal for, and the appointment, retention or discharge of these audit firm(s).

- Pre-approve the scope all services to be performed by the other external auditor.

- Review the independence of the other external audit firm(s) by obtaining statements from the audit firm(s) on relationships between these audit firm(s) and the organization, including any non-audit or non-attest services, and discussing the relationships with the audit firm(s). Obtain from management a listing of all services provided by the other external audit firm(s). Obtain information from the Chief Audit Executive and other sources as necessary.

- Review and approve the reports of the audits and/or agreed-upon-procedures.

- Provide a forum for follow up of findings from the audit reports or agreed-upon-procedures.

- Meet separately with the other external audit firm(s) on a regular basis to discuss any matters that the committee or staff of the audit firm(s) believe should be discussed privately {Subject to open meeting laws}.

- Ensure production of a report of all costs of and payments to other external audit firm(s). The listing should separately disclose the costs of any audit, other attest projects, agreed-upon-procedures and any non-audit services provided.

(7) Organization's Processes for Monitoring Compliance

- Review the effectiveness of the system for monitoring compliance with laws and regulations and the results of management's investigation and follow-up (including disciplinary action) of any instances of noncompliance.

- Review the findings of any examinations by regulatory agencies, and any auditor observations, including investigations of misconduct and fraud.

- Review the process for communicating to all affected parties the ethics policy, code of conduct and fraud policy to organization personnel, and for monitoring compliance therewith.

- Obtain regular updates from management and organization legal counsel regarding compliance matters.

- Monitor changes and proposed changes in laws, regulations and rules affecting the organization.

Example Audit Committee Charter

(8) Special Investigations and Whistleblower Mechanism

- Institute and oversee special investigations as needed.
- Provide an appropriate confidential mechanism for whistleblowers to provide information on potentially fraudulent financial reporting or breaches of internal control to the audit committee.

(9) Audit Committee Management and Reporting Responsibilities

- Regularly report to the Board of Directors about all committee activities, issues, and related recommendations.
- Perform other activities related to this charter as requested by the Board of Directors, and report to the Board.
- Provide an open avenue of communication between internal audit, the external financial statement auditors, other external auditors, management and the Board of Directors.
- Review any other reports that the organization issues that relate to audit committee responsibilities.
- Confirm annually that all responsibilities outlined in this charter have been carried out. Report annually to the Board, members, retirees and beneficiaries, describing the committee's composition, responsibilities and how they were discharged, and any other information required by rule, including approval of non-audit services.
- Evaluate the committee's and individual member's performance on a regular basis, and report to the Board.
- Review and assess the adequacy of the committee charter annually, requesting Board approval for proposed changes, and ensure appropriate disclosure as may be required by law or regulation.

Jack Ehnes
Chief Executive Officer

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HOW WILL YOU SPEND YOUR FUTURE?

November 20, 2003

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006

RE: PCAOB RELEASE NO. 2003-017;
DOCKET MATTER No. 008

Office of the Secretary:

This letter is sent to register the California State Teachers' Retirement System's (CalSTRS) support of the Public Company Oversight Board (PCAOB) proposed auditing standard regarding the attestation to the adequacy of internal controls. As you are aware, CalSTRS is a public pension fund, established for the benefit of California's public school teachers over 90 years ago. CalSTRS has assets of approximately $103 billion; $43 billion of this amount is invested in the domestic equity market. These assets represent the retirement plan for approximately 715,436 participants. The long-term nature of CalSTRS' liabilities has made us keenly interested in efforts to restore investor confidence in the capital markets. CalSTRS supports the efforts of the PCAOB to improve standards of financial reporting by publicly traded companies and to improve the ability of investors to rely on the financial statements put forth by corporations.

CalSTRS believes that the enactment of the Sarbanes-Oxley Act of 2002 was an important milestone for investors, but we also recognize that the great majority of the implementation of the legislation falls to the Securities and Exchange Commission (the Commission) and the PCAOB. We support both the Commission's and the PCAOB's efforts to accommodate the timelines articulated in the Sarbanes-Oxley Act. We do not intend to answer all 31 questions put forth by the PCAOB in its requests for comment on the issue, but we do want to register our support for an integrated audit standard and for the continued supremacy of the board of directors as the fiduciary responsible to investors in public companies.

CalSTRS believes that the external auditor should attest to and report on the internal controls assessment made by management/the issuer. Further, we believe that the board's independent audit committee should set the policies and standards relating to internal controls and have in place a procedure for informed knowledge of their application. We do not believe that the external auditor should evaluate the audit committee; we believe the standards of diligence and duty expressed in the audit committee charter, along with the various attestations and certifications required by the SEC, and the Sarbanes-Oxley Act should perform this function for investors. We believe that such a rule would pose an impossible conflict of interest for both the audit committee and the external auditor and that this tension would not serve the investors' goal of obtaining a fair opinion on the accuracy of the issuer's financial information.

CalSTRS does not believe that mandating that the external auditors perform a separate audit of the internal controls is cost effective for investors; on the one hand, the PCAOB seems to reason that the most burdensome costs will be assumed in the first year of the rule and that economies will come in subsequent years. That may be a fallacy, as seemingly, these economies would come from routine checking of the criteria/ standards/procedures imposed in the first year. This would make it a rote exercise and of little benefit to investors; so, why mandate the establishment of a system whose maintenance will not do the job that the PCAOB envisions? The independent directors are the members of the audit committee and have a fiduciary responsibility to investors in that capacity; we support letting them fulfill that responsibility. We believe that the independent audit committee should set up controls and procedures to mitigate the risks associated with inadequate internal controls and/or inaccurate financial reports. The PCAOB may want to review the charters and opine on the audit committee's diligence in mitigating the risks to the public.

Finally, we believe that the external audit opinion should be a single one; we do not support the proposal that the integrated audit result in two opinions: one on internal controls and one on the financial statements. We believe that this will be confusing to investors and will not aid in the goal of more reliable financial reporting. It is possible that internal control over financial reporting could be bad and that the reported figures present a true and accurate record, but we think it best to contain this in a single opinion.

Thank you for the opportunity to comment on this matter. If you would like to discuss this letter, please feel free to contact me directly. We are filing this comment electronically in the interest of timeliness, but you may reach me at 916-229-3706 by phone and certainly by the email address on this communication.

Sincerely,

Jack Ehnes
Chief Executive Officer

CANADIAN BANKERS ASSOCIATION

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Via email: comments@pcaobus.org

November 21, 2003

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

Dear Sir:

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

The Canadian Bankers Association (CBA), appreciates the opportunity to provide comments on the Public Company Accounting Oversight Board's proposed auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*.

The CBA is the main professional industry association, representing over 40 of Canada's domestic and foreign-owned chartered banks. Several of our member institutions are subject to the reporting requirements of the Securities Exchange Act of 1934. The CBA is also a principal contributor to the development of accounting standards that affect Canadian banks. Our member institutions make a significant contribution to the Canadian economy and six of our largest members represent, in aggregate, total assets under administration of approximately Canadian $2,863.4 billion dollars.

Our detailed comments appear in the attached Appendix. We would be pleased to answer any questions that you may have in respect of our comments.

Sincerely,

Original signed by Kelly Shaughnessy

RKS
Attachment

APPENDIX

Comments of the Canadian Bankers Association on the Proposed Auditing Standard - An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

Questions Regarding Using the Work of Management and Others:

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

We are of the view that the auditor should be free to exercise his/her professional judgment, under the guidance of the existing generally accepted auditing standards, in determining whether and to what extent the auditor can reasonably place reliance on the work of management and others. Consequently, we do not believe that the extent to which the auditor may rely on the work of others needs to be prescribed.

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

We do not believe that the extent to which the auditor may rely on the work of others needs to be prescribed. It is our view that organizations should be encouraged to have robust documentation and assessment processes. To that end, our members have made efforts to supply quality evidence to their external auditors, which has been used to reduce the extent of the auditors' independent testing.

Question 14. Does the proposed standard give appropriate recognition to the work of internal auditors? If not, does the proposed standard place too much emphasis and preference on the work of internal auditors or not enough?

We do not believe the proposed standard places sufficient emphasis on the work of internal audit. It does not give adequate recognition to the depth of experience and business knowledge resident in our members' internal audit groups. It is our view that, to the extent that such groups are competent and objective, their work should be relied upon extensively by the external auditor and that such extent need not be prescribed.

In particular, we disagree with the proposal that the auditors should not rely on others for certain information technology controls and walkthroughs.

In our member banks' organizations, the effectiveness of pervasive controls over information technology is critical to the successful execution of their business strategy. As a result, our members make substantial investments in objective and competent specialized internal audit expertise to provide assurance that these controls are designed and operating effectively for both efficiency and effectiveness, as well as for the reliability of financial reporting. These resources require in-depth knowledge of our varied and complex technology systems. Our members' external auditors have traditionally placed a high level of reliance on these pervasive technology controls and have utilized internal audit testing to a large extent in reaching their conclusions about these controls.

The proposed standard is suggesting a full duplication of effort in this area for which there is no clear benefit to the issuers or investors. The requirement will necessitate substantial new investments in technology expertise by public accounting firms that will need to be financed in the first instance by issuers, and ultimately by investors.

Similarly, the requirement to have external auditors perform walkthroughs themselves does not give adequate recognition to the depth of experience and business knowledge resident in internal audit groups. While we agree that some reperformance would be appropriate in this area if reliance is placed on the work of management and others, we believe that efficiencies can be achieved if the external auditors are permitted to use this work to support their conclusions.

Question 16. Is the requirement for the auditor to obtain the principal 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?

We do not believe that the benchmark of principal evidence is appropriate. There is no doubt that the auditor must obtain evidence that management's assertion is reliable and that the internal controls are actually in place and effective. It is our view that existing auditing standards provide sufficient guidance as to the appropriate level of effort and involvement of the auditor in executing their work and determining whether or not, and to what extent, to rely on the work of others.

The introduction of this new term raises interpretive issues in respect of the role of auditors that are unnecessary and potentially costly and divisive. Inasmuch as the concept of *principal evidence* is open to interpretation, it may lead an auditor to perform more work than necessary in circumstances where substantial testing and documentation by management, internal audit and other third parties is already in place.

<u>Questions Regarding Evaluating Results:</u>

Question 17. Will the definitions in the proposed auditing standard of significant deficiency and material weakness provide for increased consistency in the valuation of deficiencies? How can this definition be improved?

Identification of significant deficiencies and material weaknesses is necessarily an area that involves the exercise of professional judgment. Consistency is always difficult to achieve in such an area. An important step to achieving consistency will be to ensure that the definitions used in the draft standard are compatible with the overall definition of internal control and how companies evaluate and seek to mitigate risk. We have serious concerns on these matters, as discussed below.

We have concerns that the definitions of significant deficiency and material weakness in internal control in the proposed standard are impractical and overly prescriptive, inasmuch as the definitions imply that an excessively high level of assurance must be obtained in order to conclude that internal control is effective. Both of these definitions refer to deficiencies that result in "a more than remote likelihood" that financial statement errors of a certain magnitude will occur. By way of example, human error remains a constant potential issue in respect of internal control and, as such, renders the possibility of more than a remote likelihood that a misstatement will occur, and as consequence, the standard of a "more than remote likelihood" can not be achieved. The business success of our members emanates from managing rather than avoiding risk. The manner in which our members assess their controls, likewise, should allow for some risk tolerance, including acknowledgement of cost/benefit considerations.

We note that existing auditing standard AT 501 provides additional useful guidance that does not appear in the proposed auditing standard. We suggest that these qualitative considerations be brought into the final attestation standard. In particular, the notion set out in paragraph .40 of AT 501 that the consideration of whether a deficiency represents a material weakness should include consideration of the overall control environment. In recent corporate failures, many of the problems were caused by weak overall control environments and inappropriate "tone at the top." The organizations represented by our members place a high importance on having strong overall control environments and ensuring that executives and employees live up to these high standards. The significance of deficiencies in internal control cannot be properly evaluated without consideration of these matters.

The definition of internal control contemplates providing reasonable assurance that transactions are reported as required by GAAP. The proposed definitions of significant deficiency and material weakness are incompatible with paragraph 16 of the proposed standard, which indicates that management's assessment of internal control effectiveness is at the level of reasonable assurance, as is the auditor's opinion. Paragraph 16 further states that "reasonable assurance includes the understanding that there is a relatively low risk that material misstatements will not be prevented or detected on a timely basis." We suggest that existing GAAS definitions of significant deficiency and material weakness should be used instead of those proposed in the draft.

Other Comments: Use of Service Auditors Report

The wording with respect to the operating effectiveness of outsourcing arrangements described in Appendix B, paragraphs B35 to B38, implies that an auditor should place reliance on a service auditor's report as the primary source of assurance. We are of the view that a determination in favour of stronger reliance can be made from an assessment of management's processes for controlling risk. Effective management of issuers' outsourcing arrangements is in the interest of both their shareholders and their customers. The processes for controlling risk is embedded in contract negotiations, service level agreements and monitoring, input and output controls, and in some cases through the contractual right of strong internal audit areas to monitor and report on these activities.

Within the Canadian context, a "Service Auditors Report" takes the form of a section 5900 report. These reports contain less detail than the more pervasive SAS 70 review, and are typically prepared at the outsourcers' fiscal year end, which may differ more or less significantly, from the fiscal year end of our members. The lack of clarity around a "significant period of time" as noted in paragraph B37, means that our members run the risk of incurring considerable incremental costs should the definition be for a period that is less than 12 months.

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Response to …..

Proposed Auditing Standard: "AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS"

PCAOB Rulemaking Docket Matter No. 008

November 21, 2003

Prepared by:
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CARD®*decisions* Response to Proposed Auditing Standard:

"AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS

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EXECUTIVE SUMMARY

Will the draft standards improve the quality and quantity of information on internal control over financial reporting?

Our view is no, they will not. We believe Congress intended to reinforce management's accountability for reliable financial reporting by requiring auditors evaluate and form an opinion on management's assertions on internal control effectiveness. These standards are primarily for auditors to form a direct subjective opinion on internal control effectiveness through traditional audit approaches. These approaches have been in use for decades and have often proven to be ineffective.

The standards require significant revisions to focus the attention of external auditors on opining on the reliability of management's assertions on control and to guide the auditor in forming an opinion directly on the quality of those assertions.

Will the draft standards improve the capability and motivation of managers and work groups to provide more reliable assertions on internal control effectiveness and to be accountable for those assertions?

Our view is no, they will not. There is little guidance for auditors, managers, work groups Boards or any other stakeholder on the various approaches, methodologies, tools and technologies available for assessing, designing, documenting and reporting on internal control effectiveness.

There is little incentive for managers and work groups to fully and candidly divulge disclosure risks, particularly those classified as "material weaknesses".

The standards as drafted are dominated by a discussion of controls (1309 references) in the absence of serious attention to and analysis of disclosure risks (76 references). Although the proposals will generate substantial revenue for the external auditing profession and add a major ongoing assurance burden in companies, we believe they will do little to cost effectively solve the real problems.

The standards require significant revision to recognize and discuss the approaches, methodologies and tools used by assurance professions, particularly the use of criteria based approaches to forming an opinion on the quality of and reliability of management assessments.

Will the draft standards help drive down or even justify the cost of control over financial reporting?

Our view is no, they will not. They simply justify more auditing and more controls. They provide little guidance or useful definition as to what constitutes effective control and material/significant deficiencies. We believe the standards as drafted will result in a large increase in formal assurance costs with only limited positive impact.

The standards should be significantly revised to recognize more powerful and objective approaches to documenting, assessing, designing and reporting on controls and control effectiveness and to assessing the cost effectiveness of controls over financial reporting.

GENERAL COMMENTS

General comments on the Proposed Standards are set out here.

1. Will these proposed standards increase the quality and quantity of information on risks and controls related to financial disclosure?

The standards as drafted will not produce more and better information on risk and control over financial reporting.

For the most part, stakeholders will be given Pass/Fail assessments of internal control effectiveness over financial reporting developed by external auditors, supplemented by explanations of significant deficiencies or material weaknesses. The basic design of the internal control framework, its strengths and accepted deficiencies will not be reported to stakeholders. There is no framework for doing so proposed in these standards.

We see the continuation in this standard of subjective belief-based, not fact-based, auditor-driven opinions on what constitutes effective control.

We see little guidance to help auditors assess and report on the reliability of management's assertions on internal control effectiveness.

The standards as drafted struggle with concepts of "deficiencies, significant deficiencies and material weaknesses" that are for all practical purposes, indefinable and subjective to a degree that makes external disclosure of these subjective views dangerous.

Other assurance professions, most notably quality, environmental and safety professionals have developed very effective tools, methods and criteria for evaluating and reporting on risk and control in their fields. They have created meaningful analytical tools useful for identifying root cause problems and providing practical, rather than dogmatic solutions.

What is needed?

What is needed is a paradigm shift.

Stakeholders need to be able to come to their own conclusion on the role of internal control effectiveness in investment decisions and to be able to make risk acceptance decisions based on the stated level of internal control effectiveness in a corporation. A framework for gathering and reporting this information is required. Pass/Fail assessment do little to meet these needs.

Stakeholders need to be able to compare changes in a company's internal control structure over time and to compare one company to another, just as they now compare financial statements.

The information in disclosures on internal control effectiveness likely to result from these proposed standards will not support such an analysis.

It would be unthinkable to replace published financial statements with an auditor's subjective opinion on a company's financial health.

It is not sufficient to provide an opinion on internal control effectiveness without a positive framework to support such an opinion.

What is needed is a criteria-based approach to evaluating internal control over financial reporting.

Bond rating agencies rate corporate debt against defined criteria and publish credit ratings that have real financial consequences for creditors and that are relied upon by investors.

In the quality movement, the Baldrige model is an example of a system that measures a company's quality framework against defined, weighted, published criteria. ISO standards provide another example. Management makes assertions as to the criteria in place and auditors evaluate the reliability of those assertions.

The Basel Capital Accord on bank safety (Basel II) provides another powerful framework for assessing governance and the management of risk and control.

Principles from all of these frameworks could be adapted to reporting on internal control effectiveness over financial reporting.

The auditing profession, internal and external, has consistently failed to predict governance failures in the past. There is no reason to believe these proposed standards will make a difference, other than reducing returns to shareholders and retarding economic growth.

We believe the auditing profession can best add value by providing a framework for disclosing information on risk and control status such that stakeholders can make their own informed investment decisions.

2. Do these proposed standards improve the capability of managers, work groups and others to make reliable financial disclosures and to make reliable assertions on the effectiveness and status of risk and control over financial reporting?

Our conclusion is no, they do not.

The proposed standards do recognize the need to address the capability of auditors in the area of control assessment. They do not address the capability required by managers and work groups to make and support reliable assertions on internal control effectiveness over financial reporting. They do not define a common body of knowledge, tools, methodologies, approaches or technologies for assessing and reporting on internal control effectiveness over financial reporting. COSO 2003 can help in that regard. COSO 1992, although a big advancement in 1992, is not up to the task.

In order to conclude that the capability of managers and work groups to provide more reliable assertions on the status of risk and control over financial reporting is increased, much more is required to provide Boards, managers, work groups and auditors with skills training, rigorous, reliable methodologies and useful tools for describing, assessing, designing and reporting on internal control effectiveness and standards for assessing the reliability of those assertions.

For the most part, the proposed standards speak a language that is outmoded and invalid. The draft standard provides little in the way of analytical tools and guidance to managers and work groups. They appear to represent control assessment beliefs that have been in use for decades. The same decades that numerous corporate governance failures have occurred.

What is needed?

We believe that the required body of knowledge exists and the skills, methodologies and tools to increase the capability of all those involved in the financial reporting process are available. In our response to Question 5 we have provided some specific examples.

3. Will these proposed standards motivate managers and work groups to provide better and more reliable information and disclosures on risk and control related to financial reporting?

Our conclusion is no, they will not.

Managers and work groups who report “deficiencies” will effectively and immediately be penalized with adverse opinions by their auditors, more burdensome internal controls, negative market reactions and higher external audit fees. Yet we know “deficiencies” in internal control over financial reporting as defined in the proposed standards have existed for decades in hundreds even thousands of successful public companies.

As written, the proposed standards require auditors to recognize the quality of work done by managers and work groups in supporting their assertions on internal control effectiveness, but the proposed standards require substantial direct verification of internal control by auditors rather than examining and focusing on the reliability of management’s representations on control and risk status.

Unless the burden of accountability for making reliable assertions on internal control over financial reporting is clearly and exclusively assigned to managers and work groups, and they are evaluated specifically on the quality and reliability of their representations, their motivation to do so competently and reliably will be weak. Auditors will do it for them. Why should they do it themselves?

What is required?

We believe the standards should be revised to encourage a risk based approach to control design, to encourage management's candid disclosure of significant residual risks and where unacceptably high residual risks exist, to provide management with recourse to substantiate external disclosure with supplemental substantive testing and confirmation.

Standards that promote direct examination of internal control effectiveness by auditors will inevitably shift accountability away from management and with it any motivation for providing reliable representations.

Stakeholders deserve to know the quality of management's representations on the effectiveness of the external disclosure risk management systems those managers design and maintain.

4. Will these proposed standards allow a reduction in the cost and burden of implementing effective control over financial reporting?

We believe the standards as proposed will significantly increase the cost of control and the cost of non-value adding assurance. We are concerned that the increase in control will not be justified and will not result in more effective internal control over financial reporting and will not produce more reliable financial disclosures.

We believe the standards as proposed provide the auditor with justification to do more auditing. They do not add value for stakeholders of the financial reporting process.

The proposed standards use the word control(s) a total of 1309 times and the word risk(s) 76 times. All of the major advances in this field over the past decade center on identifying and measuring risks first, and only when that step has been done, and done well, examining mitigators/controls.

While word counts in the proposed standards may be only a crude measure of their emphasis and balance, we do not believe that the increased emphasis on examining controls in a vacuum from risks is appropriate.

We believe the notion of judging the design and operating effectiveness of controls as proposed in these standards, in isolation from risk or from a competent assessment of cost/benefit is fundamentally flawed.

What is needed?

The standards should be revised to give equal weight to identifying risks, examining controls and evaluating the current acceptability of the current residual risk status.

We believe the standards should adopt the concept of a portfolio of controls and an assessment of residual risk over each major disclosure line item, note and supplemental disclosure.

We believe an explicit assessment of residual risk (using an acceptable risk model and a criteria based control model) for each disclosure line item or note is intellectually more reliable and much more useful than an auditor's subjective opinion on control effectiveness.

We believe that by providing support for assertions on control effectiveness over external financial reporting management should also demonstrate they have driven the cost of control to the lowest level possible that produces an acceptable level of residual risk. To not focus on both elements in concert does a disservice to investors and to society in general.

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Questions regarding an integrated audit of the financial statements and internal control over financial reporting:

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?

Response: No. Management must be required to make and substantiate assertions on internal control effectiveness over financial reporting.

The auditor's opinion must be focused on the reliability of management's assessment of internal control over financial reporting.

An auditor's attestation of management's assessment of internal control and an auditor's direct opinion on internal control effectiveness are significantly different and are arrived at using different audit procedures.

Few, if any, of the recent corporate governance failures were predicted by either internal or external auditors from their direct opinions on internal control effectiveness. This is true in spite of companies spending large sums on internal and external auditors.

Requiring management to make and support assertions on internal control effectiveness, and requiring auditors to form an opinion on the quality and reliability of those assertions will dramatically improve the quality of financial reporting.

The auditing profession has not demonstrated that it is capable of forming consistently reliable opinions on internal control effectiveness There is nothing in these draft standards to address that severe and historic deficiency since it encourages the use of methods that have been in use for over 25 years and a control model developed 12 years ago.

To suggest that auditors must prove the reliability of management's assertions primarily by performing their own direct audit of internal control effectiveness suggests that the profession does not know how to distinguish a reliable set of management assertions on internal control effectiveness from an unreliable set of assertions on internal control effectiveness.

These standards as drafted recognize the need for the auditor to review management's assessment of internal control over financial reporting, but they stop well short of what is required to form an opinion on the quality and reliability of managements assessment Instead, they are primarily draft standards guiding the auditor in providing their own separate and direct opinion on internal control.
Unlike an auditor's opinion on management's assertions over its financial statements,

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little guidance is provided for managers to prepare and support a reliable assertion on internal control effectiveness over financial reporting.

There is no basic principal of organizing information on internal control assertions analogous to the way financial statements organize and present financial information.

There are no generally accepted and useful criteria of risk and control analogous to GAAP, and there are no adequate standards to guide auditors in forming an opinion on those management's assertions on internal control.

The standards, guidance and criteria for management to make assertions and auditors to form opinions on assertions on internal control over financial reporting are a huge missing link in the financial reporting process and one the Board is in an historic position to remedy. COSO ERM 2003 provides an initial, partially useful framework. COSO 1992 is not sufficient.

In order for an auditor to provide an opinion on management's assertions, new standards are required to provide a basis for an auditor to provide such an opinion. Such standards would require development of criteria of risk and control against which management's assessment could be measured and would require the recognition of methodologies and tools appropriate for management and work groups to use. Such standards would also specify the knowledge and skills required by management in order to prepare an assertion on internal control effectiveness.

Precedent exists for the development of such criteria and standards. The Baldrige quality model is an example of weighted criteria against which an organization's ability to produce quality products and services can be judged. Similar models and criteria exist to judge safety.

The Baldrige criteria and effective safety frameworks are based on the premise that quality and safety cannot be "inspected" into an organization.

The Basel Capital Accord on bank safety (Basel II) provides a powerful framework for assessing governance and the management of risk and control.

The history of the auditing profession would suggest that reliable financial reporting will not be "audited" into organizations.

A new paradigm is required by the auditing profession.

The PCAOB should significantly revise these draft standards to provide guidance for managers and work groups to make reliable assertions on internal control effectiveness and for auditors to form an opinion on the reliability of those assertions.

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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?

Response: No.

The question should be reversed.

"Should the auditor be prohibited from performing an audit of the financial statements without first forming a satisfactory opinion on the reliability of management's assertions on control effectiveness over financial reporting?"

The answer to the question framed this way is yes. Reliable management assertions on internal control effectiveness should be a prerequisite for an auditor to proceed with the audit of financial statements.

An opinion that management's assertions are not reliable should be considered a material weakness. An audit of the financial statements should not be undertaken until management provides reliable assertions on the status of internal control over financial reporting.

Assessing the reliability of management's assertions on internal control effectiveness should be the subject of a separate standard, however forming an opinion on the reliability of those assertions will likely involve some reperformance of procedures or substantiation of financial statement amounts.

If the auditor finds management's assertions on control effectiveness reliable and, subsequently, during the audit of the financial statements, finds information to contradict the assertions being relied upon, a material weakness should be declared.

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?

Response: No.

Evaluating and testing the basis for and reliability of management's assessment of internal control over financial reporting is significantly different than an audit of the financial statements.

It says little for the concept of internal control over financial reporting and management's assertions if professional auditors cannot directly examine internal control and the quality of management's assertions without performing an audit of the financial statements. This does not mean that substantive testing will not be required.

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If the only evidence of the reliability of internal control over financial reporting or management's assertions thereon lies in the accuracy of the financial statements, the notion of any evaluation of internal control should be abandoned.

Question regarding the costs and benefits of internal control:

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?

Response: Yes. Management may choose to develop its assertions on internal control effectiveness over financial reporting in a variety of ways and to rely in its assertions on various types and levels of internal control to achieve its financial reporting objectives.

The proposed standards recognize the concept that effective control can be achieved in a variety of ways.

However far better criteria are required to define more definitively what is meant by effective internal control over financial reporting and the notion of its equifinality.

Pass/Fail approaches to evaluate internal control effectiveness are inappropriate and do not provide the information required by stakeholders. Imagine if credit ratings were reduced to Pass/Fail judgments.

COSO 2003 provides a starting point for identifying and categorizing criteria of control, but both the original and proposed revision to COSO are far too broad to support detailed analysis, design or assessment of the status of risk and control systems.

A strong argument can be made that COSO 1992 does not meet the Board's criteria for a suitable framework for management's assessment of internal control. Although a major contribution in 1992, it has not progressed and, unlike Baldrige or the ISO standards, does not have an improvement framework.

A strong argument in favor of the proposed 2003 COSO is its inclusion of an enterprise risk framework and a process. This is essential.

Modern assurance practitioners must insist on a rigorous risk assessment as a first step in the design, evaluation or testing of controls.

In order for management to make reliable assertions on control effectiveness over financial reporting, they must develop or be provided with tools they can use to design, evaluate and report on risk and control and these tools must be practical and understandable.

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It will not be possible to ask management to make reliable assertions on internal control effectiveness with the tools the profession has provided them with to date. COSO speaks an auditor's language, not the language of a manager or work group.

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.

Response: Yes.

Guidance is essential in this area. The knowledge and skill required to competently evaluate control has increased enormously. The profession has a widespread reputation for promoting low level control practices and relying on micro control activities whose worth is dubious in the absence of any evaluation of the underlying disclosure risk.

It is worth noting that these draft standards proposed by the Board, contain over 1300 references to control(s) and only 76 references to risk(s), a strong indication of their focus.

Professional audit practices, tools, approaches or skills have not fundamentally changed in recent years in spite of evidence that old ways of auditing have often failed.

Substantial changes must be made in the body of knowledge, the skills, practices and technology used by the profession.

Furthermore, it is an appropriate role of the auditing profession, if not the Board, to suggest the knowledge, methodologies, standards, tools and skills required by management to make reliable assertions on control effectiveness over financial reporting.

Ideally, the guidance in these draft standards should be understandable and useful to managers in making their assertions and not just used by auditors in forming opinions on management's assertions.

The very definition of internal control over financial reporting could be dramatically simplified to refer to anything management or work groups do to manage risks and achieve reliable external financial reporting.

The auditing profession and management has consistently underrated the knowledge

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and skills required to design, implement, sustain and evaluate cost effective systems of internal control.

Examples of some of the knowledge required of modern auditors are:

- COSO 2003 or alternative approach to risk and control design and assessment such as the ANZ Risk Management Standards.
- Defining and prioritizing risks and financial disclosure objectives.
- Using generally accepted risk source models and other techniques to identify categorize and evaluate risks/threats to financial disclosure for the entire organization, sub-units, specific accounts and note disclosures and to create specific disclosure objectives and disclosure risk profiles/risk maps.
- Critically evaluating and using control models such as COSO and CoCo to identify, evaluate and optimize the cost of control portfolios.
- Developing reliable descriptions of residual risk status including concerns, indicator data, impact information, impediments with respect to internal controls over financial disclosure.
- The five major approaches to direct report audits and management self-assessments and business reasons for adopting self-assessment approaches to risk and control management. (Note that these Draft standards recognize only one of these five approaches).
- Barriers and implementation strategies for self-assessment approaches as a means of obtaining management assertions on risk and control and related risk acceptance decisions.
- The evolution of Generally Accepted Control Criteria ("GACC") including all major control and quality models.
- The evolution of Generally Accepted Risk Criteria ("GARC") including the leading risk standards and frameworks from around the world.
- Integrating insurance and risk transfer decisions with risk and control design analysis and decision-making.
- Linkages between Basel Committee requirements for financial institutions in the area of risk and control and the linkages between the 5 stages of enterprise risk management described in *Operational Risk: The Next Frontier* study published by the RMS, ISDA and British Bankers Association and other major approaches such as COSO 2003..
- The business case and benefits for enterprise risk management system as a means of driving, integrating and sustaining ongoing assessments and evaluations of internal control over financial reporting.
- Strategies to integrate performance management, risk and control management,

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assurance management and knowledge management with financial reporting.

- Completing quality assurance reviews (audits) of risk and control analysis completed by management and work units to evaluate the reliability of management's assertions.
- Basic principles used to develop estimates of the cost of control and the cost of assurance

Questions regarding evaluation of management's assessment:

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?

Response: No.

An auditor's opinion focused on the reliability of management's assertions on internal control effectiveness over financial reporting is required.

Such an opinion would require an evaluation of the scope, processes, tools, methodologies, participants, and quality procedures in place and used by management in preparing and supporting their assertions on internal control effectiveness.

Such an opinion would also require some direct examination of evidence of internal control, but the opinion itself and the focus of the audit evidence would be on the reliability of management's assertions and not on opinion on internal control effectiveness.

Management must be fully responsible for its opinion on internal control effectiveness and status.

These draft standards do not provide sufficient guidance to allow an auditor to express such an opinion.

If the existence of effective systems of internal control and the reliability of management's assertions over internal control effectiveness cannot be directly examined and opined on, as opposed to an examination of the results of effective internal control, then the profession should remove any discussion of internal control from its standards and focus entirely on substantive verification of account balances and reliability of note disclosures.

An auditor's direct evaluation of internal control over financial reporting has been historically unreliable, will be not be improved by these draft standards, and is not in any way a substitute for an opinion on management's assertions on control effectiveness over financial reporting.

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

Response: No.

Criteria to evaluate the adequacy of management's documentation is secondary.

Criteria are needed to evaluate the reliability of management's assertions on internal control over financial reporting.

Specifically, criteria are needed to evaluate the scope, processes, tools, methodology, participants, quality assurance mechanisms management and technology, if any; management uses to make its assertions on internal control effectiveness.

Standards governing documentation may be a subset of the broader criteria. But the extent and quality of the documentation is secondary to the content and procedures the auditor must follow.

Specifically, there is no provision in the draft standards relating to the auditor's evaluation of management's assessments of risk to determine what could prevent adequate disclosure for financial statement line items, note disclosure or other matters. For example, what constitutes a sufficient analysis of risks to a reliable external disclosure as a basis for identifying critical controls that should be tested is not discussed.

There is no reference to the use of risk models in assessing risk. While the use of COSO 2003 is encouraged, its flaws when used for more than macro level risk and control analysis and design at a specific disclosure process level are not recognized in these draft standards.

Arguably the original 1992 COSO framework does not meet the requirements for a framework suggested by these draft standards. The 2003 revisions are preferable in that they still require some risk assessment but they require improvement to be useful to management.

Only one approach, the process based assessment approach, is suggested in this standard as a methodology for assessing controls related to financial disclosure. At least four other assessment approaches are in general use individually or in combination.

There is little reference to the use of control and risk self-assessment approaches or guidance on how or where such approaches may be appropriate to evaluate risk and control in spite of the use of self assessment by many assurance professionals and many companies.

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Without a rigorous risk assessment, key controls will not be identified, assessed or documented by management or properly considered by auditors. Nor is it likely that management will find the control evaluation process credible and valuable.

These draft standards are overwhelmingly focused on imposing controls that the auditor subjectively believes may be effective. A word count reveals that the word control(s) appears over 1300 times in the draft standards while the word risk(s) appears only 76 times.

The draft standards do not provide guidance on what constitutes adequate risk assessment and only limited guidance on tools, methodologies and approaches to assess, design and report on control effectiveness.

An opinion on management's assertion on internal control effectiveness is not possible without reviewing the quality of managements risk assessment over disclosure.

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?

Response: Yes.

The questions posed in #8 are too narrow. The draft standards should deal with far more than documentation. The draft standards should deal with the content as well as the amount and quality of the documentation. Ideally the draft standards would also recognize, if not prescribe, the appropriate use of technology for documentation of risks, controls and residual risk status.

Management can and must be responsible for defending its assertions on control effectiveness over financial reporting. In addition to documentation, the auditor should examine the scope, processes, methodology, approach, participants, and tools, including technology, used by management in documenting risk, control and residual risk acceptance decisions.

The reliability of management's assertions on internal control effectiveness can be called into question if any of these factors are flawed.

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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?

Response: Yes.

Walkthroughs are a minor part of the auditor's examination and insufficient to form an opinion either on management's assertions or on internal control itself.

Another more relevant way of asking the question is "Are the criteria sufficient to evaluate management's assertions on internal control effectiveness or to directly verify internal control effectiveness discernable to an auditor performing a walkthrough of the company's significant financial processes?"

The answer to that question is no.

Walkthroughs in the context of these draft standards take place at the transaction or system level. They may be an appropriate measure where the auditor requires evidence that processes are functioning as described by management. But they are not worthy of the attention they receive or the reliance placed on them in these draft standards.

They are indicative however of the relatively narrow view of internal control implied by the draft standards.

Many modern criteria based control and quality frameworks weigh leadership, capability, measurement and commitment far more heavily than the control activities susceptible to walkthroughs. In fact, some virtually ignore micro level control activities on the theory that if the broader elements are in place, control activities will follow.

Generally, breakdowns in control activities that would be seen in walkthroughs should be seen as symptoms of fundamental control issues and not as problems in and of themselves (e.g. employee failure to comply with a policy may be a symptom of poor training or a failure of management to make objectives and priorities clear).

What role did failures of transaction based processes play in the fraudulent and inaccurate financial reporting of the last decade? Little or none in many instances.

It is unlikely that walkthroughs would have detected the root causes of fraudulent financial reporting and inaccurate financial disclosure that these draft standards attempt to address.

The root causes of fraudulent financial reporting do not lie at the process or transaction

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level of the organization.

When criteria are developed for the evaluation of internal control over financial reporting, the usefulness of walkthroughs as an evaluative procedure can be assessed.

The corporate financial reporting failures that led to the formation of the PCAOB will not be found by walkthroughs.

Walkthroughs might reveal individual process failures or inefficiencies but they will not look on the right level, on the right things, on the right behaviors or on the right people to be of significant use to achieve the goal of these draft standards.

The extent of their use should be a matter for practitioner discretion and not a matter for these draft standards.

Effective Internal control over financial reporting lies in the behavior of the organization's leaders and its employees. The quality of the organization's leadership and its influence on the behavior of the organization must be considered.

Unreliable financial reporting is essentially a quality problem. The quality movement has determined that the drivers of quality in manufacturing, like the drivers of quality in financial reporting, begin far from the factory floor.

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?

Response: No.

It is appropriate for the auditor to query management's processes for evaluating and reporting on the effectiveness of internal control over financial reporting.

It is appropriate for the auditor to ask management how they ensure that controls are operating as described.

If management does not perform a walkthrough of significant processes, or demonstrate reliable knowledge of the controls in use, a deficiency should be noted and the reliability of their assertions on internal control effectiveness adjusted downward by the auditor.

Where management is relying on controls susceptible to verification by walkthrough, it is reasonable for the auditor to ask for evidence of the walkthrough.

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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?

Response: No.

It is management's job to obtain evidence of the effectiveness of controls annually, management's job to determine the most relevant assertions annually and management's job to demonstrate annually to the auditor that they have done so and done so reliably.

It is the auditor's job to form an opinion on the reliability of management's assertions.

In the course of forming an opinion on management's assertions it will be appropriate to review some of the evidence provided by management to support their assertion.

Accordingly, for the most part, the evidence the auditor will be obtaining to support an opinion on management's assertions will be based on the evidence management provides. Such evidence will consist of the scope, processes, tools, level and quality of employee involvement, approach used and technology employed as well as information on risks, controls and residual risk status with respect to achieving the objectives of reliable financial reporting.

In particular, in evaluating management's assertions on control effectiveness over financial reporting, the auditor should pay particular attention to the risk assessment process undertaken by management to identify and evaluate the risks to accurate financial reporting.

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?

Response: The work performed by management and others in forming an opinion on internal control effectiveness should be the primary source of audit evidence.

The auditor should be required to specifically evaluate the quality and reliability of work provided by management and others and to assess and report its reliability. In particular this includes management's representations on the controls in use and on residual risk status.

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If the auditor does not find the work performed by management or others to be complete, accurate or reliable, the auditor should provide an opinion to that effect.

Assessing the reliability of work performed by management and others may include reperformance of portions of that work.

However, only if and when the auditor cannot rely on the assessment work of management and others should it be disregarded.

Where the work performed by management and others to form an opinion on internal control effectiveness is insufficient and unreliable, the deficiency should be remedied before the auditor proceeds to express an opinion on the financial statements.

These draft standards should provide specific guidance on how to form an opinion on the reliability of assessment work performed by management and others.

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

Response: No.

The three categories of controls, specifically those that are part of the control environment, controls over the period end financial reporting process and controls that have a pervasive effect on the financial statements, if they are truly important, are exactly the areas where management must make and support its strongest assertions.

These three areas are those in which the auditor must provide the highest level of assurance over management's assertions.

If an external auditor cannot rely on management's assertions in these areas, they should report a material weakness and not proceed further until the inaccurate or even fraudulent assertions are remedied.

This places a significant and completely appropriate burden on management to honestly and competently describe, document and support their assertions in these areas. It places a significant and completely appropriate burden on the Board and the profession to provide the necessary standards and criteria to guide management in preparing and documenting their control effectiveness assertions.

The auditing profession has not demonstrated to date that it is capable of directly and consistently providing reliable opinions on internal control effectiveness in these areas. Management letters on control produced by external auditors have been criticized by our clients all over the world.

These are precisely the areas where investors and all other stakeholders must find

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management's assertions reliable and where an auditor's opinion on the reliability of those assertions will have most value.

This is the area where the PCAOB should be focusing its standard setting activities.

Forming an opinion on management's assertions will require verification by the auditor and the extent and nature of the verification will be based to some degree on professional judgment and will involve some degree of reperformance to test the reliability of management representations.

But if management cannot or does not provide reliable representation on control effectiveness, all stakeholders who rely on an auditor's opinion should be told.

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?

Response: No.

These draft standards do not appropriately recognize the role played today by internal auditors, the role they could play in the future and the value of the work they perform.

Internal auditors are an important part of the internal control framework and the work they do must be evaluated as part of the audit of management's assertions on internal control over financial reporting.

A new and very appropriate role of internal auditors is to evaluate the organizations risk and control management's processes. This is one of the new Internal Audit Standards issued by the Institute of Internal Auditors. If internal auditors are professionally and technically competent and provide reliable information on the state of internal control and the reliability of management representation on risk and internal control management, it should be relied upon to a significant degree.

If the work of internal auditors is found to be unreliable, the external auditor should report a major deficiency in internal control that is, with certainty, a material weakness.

Failing to assess the quality and competence of the work performed by internal auditors as a basis for relying on such work is a significant omission in these draft standards.

Internal auditors must be held fully accountable for the quality of their work. That includes work assessing control directly and work reporting the reliability of management self-assessments.

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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)?
Response: No. Flexibility in determining the extent of reperformance of the work of others is appropriate. Reperformance may be efficient, but reperformance is not a substitute for forming an opinion on the reliability of management's assertions on internal control effectiveness. Reperformance should primarily be considered as a means of obtaining assurance where the highest level of assurance is required. The extent of its use should be at the discretion of the auditor and not mandatory.
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?
Response: No. Management is responsible for providing the principal evidence to support internal control effectiveness representations. The auditor is responsible for obtaining evidence that management's assertions are reliable. Evidence for this opinion will primarily lie in an examination of the scope, tools, procedures, methodologies, approaches, participants and technology employed by management in arriving at the assertion. The amount of work to be performed by the auditor should be directly related to the quality of management's assertions on internal control effectiveness. Standards to guide the auditor in the evaluation of management's assertions are required and those standards should address the amount of principal evidence on internal control effectiveness to be obtained by the auditor.

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Questions regarding evaluating results:

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?

Response: No.

It is safe to assume that every company required to report under Sections 302 and 404 will have, at any given time, a number of deficiencies, many of them significant.

It is also safe to assume that every public company will, over time, have one or more material weaknesses.

Candid disclosure and correction of significant deficiencies and material weaknesses will be discouraged by these draft standards.

The quality of a company's system of internal control over financial reporting and management's assertions should be rated and disclosed with reference to criteria.

Investors, regulators and other stakeholders may make their own judgments and act accordingly.

Similarly, public companies will occasionally experience financial losses or write-offs.

Denying an opinion on financial statements because of a financial loss or write-off would not be acceptable.

Investors, employees and other stakeholders may come to their own conclusion on stakeholder risk when given reliable information on the external disclosure processes.

The Baldrige quality model provides for scoring an organizations quality framework against a set of weighted, predefined criteria. The criteria are regularly updated and improved.

Bond rating agencies similarly score and publish corporate credit ratings based on established criteria related to credit worthiness.

Some rating organizations are assigning and publishing corporate governance ratings for public companies based on defined and disclosed assessment criteria.

The Board and the auditing profession have the opportunity to develop a similar method for assigning a score or rating on internal control effectiveness.

Such a system, to be credible and rigorous, would require input from the profession and

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from companies. It would allow investors and others to compare companies over time and across industries. Defined criteria would be updated regularly. It would make the evaluation of internal control effectiveness transparent to management, employees, other stakeholders, auditors and regulators.
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?
Response: No. Examples must focus on situations where management's assertions are determined to be unreliable. Examples should also include situations where management has disclosed significant deficiencies or material weaknesses and proposed remedies or substituted other procedures to support the reliability of external disclosures. For years, external auditors have chosen, in their audit of financial statements to perform substitute substantive testing rather than rely on internal control effectiveness. Management may wish to do the same if they believe significant deficiencies or material weaknesses exist. Internal control effectiveness must be measured against defined criteria and not against subjective auditor driven opinions of deficiencies and weaknesses. Examples must include sample of reporting against criteria of risk and control.
19. Is it necessary for the auditor to evaluate the severity of all identified internal control deficiencies?
Response: No. It is necessary for management to evaluate the severity of all identified internal control deficiencies. It is appropriate for the auditor to review management's process for doing so as part of their evaluation of management's assertions on internal control over financial reporting.

CARD®*decisions*' Response to PCAOB

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?

Response: Yes.

It is the responsibility of management to report all disclosure risks and internal control deficiencies (not just material weaknesses and significant deficiencies, however defined) to the auditor.

It is not intellectually possible for management to form an opinion on internal control effectiveness over financial reporting without knowing the deficiencies that are being accepted. Effective control can be defined as an acceptable level of deficiencies related to external financial disclosure. It stands to reason that they must be known and assessed to be responsibly considered acceptable by management.

The completeness and detail with which management reports disclosure risks and internal control deficiencies is a measure of the quality of their assertions on control effectiveness over financial reporting.

If the auditor finds additional deficiencies not reported by management, they must be reported to management and management's process for evaluating control effectiveness adjusted.

Auditors must take into account any deficiencies they find that were not reported by management in forming their opinion on the reliability of managements assertion on control effectiveness.

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

Response: Yes.

These indicators would contradict any management assertion that internal control over financial reporting is effective.

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?

Response: No.

Management should consider the role of the Board during their self-assessment of internal control over financial reporting. External auditors are hired by the audit

CARD®*decisions*' Response to PCAOB
committee. Reporting on their employer's competence directly is an inherent conflict of interest. Criteria are required to assess the role and reliability of the Board in assessing control over financial reporting.
23. Will auditors be able to effectively carry out their responsibility to evaluate the effectiveness of the audit committee's oversight?
Response: No. It is difficult to believe auditors, appointed by the Board, remunerated by the Board and evaluated themselves by the Board, could be considered credible in forming an opinion on the audit committee's oversight. This section, if it stands, will almost certainly cause external auditors to give unreliable opinions.
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?
Response: Yes.
Questions regarding forming an opinion and reporting:
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?
Response: No. Management may disclose a material weakness yet still provide reliable support for financial disclosures through other means. If internal control is evaluated against defined criteria and given a score this question becomes irrelevant. It is possible for a company to be assigned an extremely low score against a set of defined criteria. Investors, regulators and other stakeholders may be guided accordingly. Similarly, it is possible for a company to report huge losses, even to enter bankruptcy, while conforming to GAAP.

CARD®*decisions*' Response to PCAOB
26. Are there circumstances where a qualified "except for" conclusion would be appropriate?
Response: No. Internal control effectiveness should be scored against predefined criteria. Direct opinions on internal control effectiveness are extremely subjective and have proven to be of limited value.
27. Do you agree with the position that when the auditor issues a nonstandard 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?
Response: No, for all the reasons cited in our other responses.
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?
Response: Yes.
29. Are there any specific internal control-related non-audit services the auditor should be prohibited from providing to an audit client?
Response: Yes. If the auditor is providing an opinion on management's assertions on internal control effectiveness, it is difficult to see how the auditor can be independent if they provide any internal control-related services or play a significant role in producing any of the external disclosures including tax provisions, deferred tax balances and many others. The question might better be "Are there any specific internal control-related non audit services a client should be permitted to obtain from their auditor?" Many external auditors play a significant role in determining a client's tax provision and interpreting generally accepted accounting principles. This is an inherent conflict. Many auditors play a significant role advising on interpretation of GAAP or on appropriate financial disclosure. These roles have an inherent conflict. Surveys indicate a high percentage of companies (40% to 50%) select control

CARD®*decisions*' Response to PCAOB
assessment software recommended or provided "free" by their auditor. Auditors have a huge influence on companies internal control frameworks when they recommend software or propose "best practice" controls or control checklists. These represent significant inherent conflicts, particularly when providing an opinion on the reliability of management's assertions on internal control effectiveness.
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?
Response: Yes.
31. Is the scope of the auditor's responsibility for quarterly disclosures about the internal control over financial reporting appropriate?
Response: Yes.

Professional Profile

Bruce W. McCuaig, B.Comm., CA·CIA, CCSA

Bruce McCuaig joined CARD®*decisions* in 1995. Prior to joining CARD®*decisions* Bruce held senior executive positions with Gulf Canada in Calgary and Toronto and Gulf Oil Corporation in Houston, Texas. While General Auditor of Gulf Canada Resources in 1987, Bruce implemented the original work team self-assessment concepts, including development of officer and board level presentations outlining the benefits of this new approach. He directed the first series of CSA pilots conducted during the summer of 1987 presented by Tim Leech and Paul Makosz.

Bruce's experience includes extensive audit and financial management in the oil and gas industry, both upstream and downstream, as well as exposure to the mining and banking sectors.

Since joining the firm in 1995 Bruce has worked with clients around the world training and overseeing complex, innovative Enterprise Risk & Assurance Management ("ERAM"), Control & Risk Self Assessment ("CRSA"), and Collaborative Assurance & Risk Design ("CARD® ") implementation initiatives in public and private sector clients ranging in size from individual departments to some of the world's largest multi-national corporations.

Bruce is an experienced speaker, author and presenter, participating regularly in international conferences on the subject of control self-assessment and publishing in professional audit and financial journals.

Some of Bruce's specific experiences and achievements include:

- General Auditor of Gulf Canada from 1983 to 1988 with responsibility for directing over 80 professional staff.
- Pioneering the use of a conceptual control framework for training, assessment and reporting purposes in Gulf Canada in the fall of 1986.
- Co-authoring a technical response to the Treadway Commission exposure draft in 1986 outlining the benefits of control self-assessment and the use of a control model for training and reporting.
- Co-authoring two important articles on Gulf's initial experience with and learnings from the control self assessment experience: "Is Everything Under Control? A New Approach to Corporate Governance", McCuaig/Makosz, Financial Executive Magazine, January/February, 1990 and "Ripe for a Renaissance", McCuaig/Makosz, Internal Auditor Magazine, December, 1990.
- Winner of Internal Auditor Magazine's Outstanding Contributor Award for 1990.
- Frequent speaker at IIA Conferences, Control Assessment Conferences and Government/Industry Associations.
- Hands-on experience assisting clients with complex enterprise risk management and enterprise risk implementations in large client organizations.
- Training and consulting for public and private sector staff in Canada, the U.S., the U.K., Holland, Greece, Australia, New Zealand, Malaysia, Hong Kong, the Middle East and Africa.
- Wrote "The Genesis of CSA", CSA Sentinel, May 1997 and "Audit, Assurance and CSA", Internal Auditor Magazine, June 1998.
- Co-authored "CRSA Current State of the Art, Its Origins and Impacts" published in Control Self-Assessment for Risk Management and Other Practical Applications published by John Wiley & Sons.

Professional Profile
Tim J. Leech, FCA·CIA, CCSA, CFE, MBA

Tim J. Leech is the founder and President of CARD®*decisions* Inc. based in Mississauga, Ontario, Canada. Previously, Tim was the Managing Director of the Canadian subsidiary of Network Security Management Ltd., part of the Hambros Bank group of companies headquartered in London, England. He also served as Director - Control & Risk Management Services with The Coopers & Lybrand Consulting Group in Toronto after a varied career with Gulf Canada in Toronto and Calgary. He holds a Master in Business Administration degree majored in human resources and was elected Fellow of the Institute of Chartered Accountants in recognition of distinguished service to the profession.

Leech's practice includes enterprise-wide risk and assurance management; Collaborative Assurance & Risk Design™ ("CARD®") software development, training and consulting; control and risk self-assessment ("CRSA") training and implementation services; specialized litigation support services; business ethics advisory services; internal audit training and consulting; and control/risk governance consulting services. He has provided training for public and private sector staff located in Canada, the U.S., the European Community, Australia, South America, Africa and the Middle and Far East. Leech has received worldwide recognition as a pioneer in the fields of enterprise risk and assurance management, Collaborative Assurance and Risk Design, and control and risk self-assessment.

Some of Leech's experiences and achievements include:

- pioneering and developing a work team driven approach to control and risk management and reporting that has been recognized globally as a leading edge, control and risk management tool;
- developing Collaborative Assurance and Risk Design™ training methods and software used by major organizations around the world. Some of the organizations that have acquired licences over the past decade to use CARD® training tools internally include: BellSouth, British Gas, Shell U.K., Georgia-Pacific, NatWest Bank, University of California, CIBC, Mobil, Cabot Corporation, Ansett Airlines, TD Bank, NorthEast Utilities, Chiquita Brands, Compart, City of Detroit, Telephone and Data Systems, Telstra, Western Mining, Canada Life, and Australian Taxation Office;
- numerous T.V. appearances, a national radio show, and a monthly column on control, ethics, and fraud related topics;
- authoring technical papers in response to exposure drafts of control governance studies in the U.S., the U.K., and Canada including reports by the Treadway Commission, COSO, Cadbury, and CoCo internal control research projects and the new standards exposure from the IIA;
- developing technical material for research studies on CSA/CRSA including the IIA report CSA: Making the Choice, the IIA research study CSA: Experience, Current Thinking and Best Practices and a text published by John Wiley titled "Control Self-Assessment for Risk Management and Other Practical Applications";
- delivery of expert witness services and testimony during civil and criminal actions related to fraud, secret commissions, conflict of interest, breach of contract, and officer/director due diligence;
- developing training tools that have proven effective in a wide range of nationalities and cultures. Training on CARD® methods and tools is available in English, Spanish, German, Dutch, French, and Italian through Oxley Fitzpatrick in the U.K., Rosés Auditores in Spain, and participating KPMG offices located around the world;
- member of the I.I.A. Enterprise Risk & Self-Assessment Advisory Panel and author of the IIA CCSA practice exam; and
- primary author and developer of CARD®*map* software - the world's first Collaborative Assurance and Risk Design™ groupware. CARD®*map* software is used by major companies and public sector organizations around the world.

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CardinalHealth

November 14, 2003

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D. C. 20006-2803

Dear Board Members:

Cardinal Health, Inc. ("Cardinal") respectfully responds to the invitation to comment on *Proposed Auditing Standard-An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* ("Document"). Cardinal is a leading provider of products and services supporting the health-care industry. Cardinal, which is headquartered in Dublin, Ohio, employs more than 50,000 people on five continents and produces annual revenues of more than $50 billion. We appreciate this opportunity to provide you with our views on the Document.

As Cardinal is not a public accounting firm, a number of questions were not applicable or it was not appropriate for Cardinal to respond. As such, Cardinal's responses to select questions are listed below. The question from the Document is restated in bold type and Cardinal's response follows in normal type.

- **Question 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 an audit of internal control over financial reporting?"**

  No, we do not believe that it is appropriate to refer to the work proscribed by the relevant provisions of the Sarbanes-Oxley Act ("Act") as an audit because it is our belief that in order to do such the rules are inaccurately interpreting the mandate of the Act. The Act specifically calls for an attestation of management's assertion, not for an audit of the internal control structure. We believe that the PCAOB rules should only address what Congress mandated in the Act and not expand upon them.

- **Question 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?"**

  We believe that it is appropriate to state that inadequate documentation is an internal control deficiency, the severity of which should be evaluated by the auditor. However, the rules should not lose sight of the fact that the key objective is to provide investors with assurance that the company has an effective system of internal controls surrounding financial reporting in place and operating. Lack of adequate documentation may in fact be just that, while strong controls are in place and operating effectively.

- **Question 13 and Question 14: "Are the three categories of controls and the extent to which the auditor may rely on the work of others appropriately defined?" and "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?"**

  Regarding paragraph 104, we strongly disagree with prohibiting the use of the results of testing performed by a competent and objective internal audit function in the following areas:

  - Controls over the period-end financial reporting process, and
  - Information technology general controls on which the operating effectiveness of other controls depend.

  Internal audit functions routinely exhibit complete competence in performing this work and are, in most cases, not involved in the design and performance of procedures in both of these areas. To completely discount and disregard the validity of past reliance that the independent auditors have placed on internal auditors in financial statement audits is in no way justified. We would concur that the independent auditor should exercise careful judgment in these areas as to how much re-performance of the internal auditor's work should occur, but to dismiss the value that a competent and objective internal audit function can contribute in these areas is ungrounded, especially internal audit functions that are complying with professional standards established by the Institute of Internal Audit's "Standards for the Professional Practice of Internal Auditing."

  Similarly, the guidance in paragraph 10 that the use of procedures performed by internal audit should be limited for non-routine and nonsystematic transactions plus areas where the risk of control failure is high seems unduly restrictive. It would, perhaps, be more reasonable for the standard to require the independent auditor obtain direct independent evidence in these areas to complement the work done by the internal auditor. However, to proscribe that in all cases the independent auditor's use of internal audit's work in these areas be limited is an unmerited diminution of the effectiveness and reliability of a competent internal audit function.

- **Question 17: "Will the definitions in the proposed standard of significant deficiency and material weakness provide for increased consistency in the evaluation of deficiencies?"**

  While the new definitions may promote consistency, we believe that the new definitions are too restrictive and may be interpreted as setting unrealistically low thresholds. We believe that the concept of "remote likelihood" and "more than inconsequential" used to define a significant deficiency and "remote likelihood" used to define a material weakness set unnecessarily low hurdles for companies. We believe that lowering the threshold will have unintended and chilling consequences in the business world and urge the PCAOB to reconsider these definitions before issuing the final rules. In addition, we would like to see the final rules address the role of mitigating controls in the text and examples. Finally, we believe that further clarity is required affirming that a significant deficiency or material weakness is not automatically present in financial processes involving a large volume of transactions that requires reserve provisions for transactional conflicts pending further research and negotiation. We believe these situations would typically not be considered as a significant deficiency or material weakness.

- **Questions 25 and 26: "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?" and "Are there circumstances where a qualified "except for" conclusion would be appropriate?"

Paragraph 115 of the draft standard essentially states that if the independent auditor determines that there is a material weakness, then an adverse report must be issued. This requirement, when taken in combination with the new material weakness definition in paragraph 9 imposes a substantially lower hurdle that in our view is unrealistic. "Remote likelihood" appears to be an unnecessarily conservative and somewhat arbitrary restriction for a judgment that will result in an adverse report. In addition to reconsideration of "remote likelihood," we believe there should be some reconsideration of a qualified report for isolated or less pervasive material weakness situations, reserving the adverse report for those circumstances with several material weaknesses and an overall weak control environment.

- **Other matters:**
  - Cardinal is a company that will, under current regulations, be required to provide management certification and auditor attestation in its annual report for the year ended June 30, 2004. As such we are currently working to meet these anticipated requirements. This process is a significant undertaking and, given the fact that the PCAOB will not even propose final rules to the SEC until January 2004 and that the SEC will not issue final rules until sometime thereafter, it seems unrealistic to hold companies to an effective date of 6/15/2004. We urge the PCAOB to request the SEC to delay the effective date until a later date, to ensure the appropriate amount of time to get this critical auditing standard right the first time.
  - We urge the PCAOB to provide guidance or relief in situations where major acquisitions occur close to a company's fiscal year end. The proposed rules should not hinder how businesses operate but the magnitude of work involved to evaluate acquired companies financial reporting internal control structures will hinder management's ability to attest as of fiscal year end when large acquisitions have been completed in a close proximity to the acquirer's fiscal year end.

Sincerely,

Richard J. Miller

Richard J. Miller
Chief Financial Officer

CC: John Finn, Audit Committee Chairman

CATERPILLAR®

Caterpillar Inc.

100 N. E. Adams Street
Peoria, Illinois 61629

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

Ladies and Gentlemen:

Caterpillar Inc. commends the Public Company Accounting Oversight Board (“the Board”) and its staff for the thorough and expeditious manner in which you have discharged your responsibilities. Caterpillar would like to thank you for the opportunity to comment on your proposed auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (“the proposed standard”).

For more than 75 years, Caterpillar Inc. has been building the world's infrastructure, and in partnership with Caterpillar dealers, is driving positive and sustainable change on every continent. A Fortune 100 company, Caterpillar is the world's leading manufacturer of construction and mining equipment, diesel and natural gas engines and industrial gas turbines. The company is a technology leader in construction, transportation, mining, forestry, energy, logistics, electronics, financing and electric power generation.

Over the years, Caterpillar has built a solid reputation as a highly ethical company. We recognize and take seriously our role in restoring public confidence in Corporate America, including our responsibility to maintain an effective system of internal controls. We also acknowledge that the external auditor’s independent oversight role is critically important to this restoration. Accordingly, we support, in principle, the Board’s goal of enhancing the effectiveness of internal control over financial reporting. However, we believe the proposed standard exceeds the intended requirements of Section 404 of the Sarbanes-Oxley Act (“the Act”) and is insensitive to the cost of compliance for U.S. companies and audit firms. We believe the proposed standard, as written, sets forth requirements that create a cost disadvantage and operational disruptions for U.S. companies versus foreign competitors. In our opinion, the disadvantages to implementing the proposed standard will far outweigh the benefits to investors in public companies.

Please accept our comments to the Board's specific questions in Attachment I in the constructive manner in which they are intended. The following summarizes our key observations and concerns:

- ***Adverse consequences and costs of implementation and on-going compliance with the proposed standard***

  We believe the following provisions of the standard will impose significant, unintended consequences and costs to implement and comply on a continuing basis:

  Restricting the auditor's reliance on the work of management and others -- In our opinion, paragraphs 103-110 represent the most onerous provisions of the standard and will cause significant and unnecessary duplication of effort by the external auditor, internal auditors, and management. **We strongly object to the limitations placed on the external auditor in relying on the work of others.** We agree that the work of others cannot replace the work of the external auditor. However, we believe the auditor should be allowed to rely on competent, objective internal auditors, and to a large extent management, similar to the reliance permitted under Statement of Auditing Standards No. 65 (SAS 65), *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*. This reliance should not be limited to the internal auditor's tests of routine transactions and processes.

  We understand the importance of auditor independence from management. **However, the collaborative relationship that often exists between the external and internal auditors is extremely effective and cost-efficient in providing the broadest audit coverage and greatest level of assurance to investors.** This collaborative assurance is greatly reduced under the proposed standard.

  Furthermore, we believe the scope of the auditor's work under the proposed standard exceeds the scope intended in Section 404 of the Act. In our opinion, the scope of the auditor's work was intended to be an attestation of management's assertion of the process used to evaluate the effectiveness of internal controls; not an audit of internal controls. Requiring the same level of assurance from both management and the auditor will unnecessarily require significant and duplicative work.

  Prescriptive audit procedures -- We do not believe the proposed standard sufficiently permits the external auditor to use professional judgment in designing and executing audit strategies and procedures. For the same reasons the Board concluded internal control is not "one-size-fits-all," audit procedures should not be "one-size-fits-all." It is our belief the auditor should be allowed the latitude to apply audit strategies and procedures based on the auditor's trained and professional judgment, the size and complexity of the organization, and the competence and objectivity of management.

We agree that walkthroughs of significant processes, limited rotation of audit procedures, and year-to-year unpredictability of testing can all be effective audit procedures and strategies. However, we believe the application of these strategies and procedures should be the discretion of the auditor based on the numerous and varied factors affecting management's assertion regarding the effectiveness of its internal controls.

Appropriate consideration of well-controlled companies -- We agree with the Board that an effectively designed internal control framework, must have the five components of internal control. However, we believe the proposed standard focuses too narrowly on the auditor's responsibilities with respect to only two of those components -- *Control Activities* and *Monitoring.* We do not believe the proposed standard's restricted use of others' work and the prescriptive nature of the audit procedures enable the auditor to consider the *Control Environment, Risk Assessment, and Information and Communication* components of the framework in determining the nature, timing and extent of his/her work.

A strong internal control framework, including proper interaction of the five components, should enable the auditor to rely on the work of others, rotate audit focus, and design audit strategies and procedures that are commensurate with the internal control risk environment.

- ***Evaluating the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting***

We agree that an effective audit committee is an important monitoring control and is essential in maintaining an effective control environment. Accordingly, effective audit committee oversight is yet another control expected in the overall internal control framework. Therefore, in our opinion, the specific requirement that the external auditor evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is unnecessary. Furthermore, because the audit committee is charged with oversight of the auditor, including their appointment, compensation, and dismissal, this relationship could preclude the auditor from making an unbiased evaluation.

Additionally, we do not believe it is appropriate for the auditor to evaluate aspects of the audit committee where there is no measurable criteria (e.g., amount of time the audit committee devotes to control issues), or require the auditor to evaluate aspects of the audit committee for which the board of directors has already performed (e.g., independence of audit committee members from management, committee's compliance with listing standards, whether the committee includes a financial expert).

We believe the audit committee is best evaluated by the board of directors.

- ***Definitions and reporting of significant deficiency and material weakness in internal control over financial reporting***

  Under the proposed standard, a significant deficiency or material weakness can exist as either a single deficiency or a combination of deficiencies. In our opinion, the definitions as worded, could guide the auditor to evaluate a single internal control deficiency as a significant deficiency or material weakness without regard to the entire internal control framework or other mitigating controls. We urge the Board to recognize that an effective internal control framework consists of numerous, interrelated control activities and processes and that a single control is seldom effective on a standalone basis. Rather, the effectiveness of controls depends on all five components of the control framework.

  Furthermore, we believe the terms *"more than inconsequential"* and *"more than remote"* unreasonably lower the bar, vis-à-vis FAS No. 5, in evaluating whether control deficiencies represent reportable conditions. In our opinion, terms used in the definitions in paragraphs 7 through 9 of the standard should be more closely aligned with FAS No. 5.

* * * * *

We welcome the opportunity to discuss these issues at your convenience. If you have questions regarding this letter, please contact Mr. Ali Bahaj at (309) 675-4212.

Sincerely,

Ali M. Bahaj
Vice President
Auditing & Compliance Division
Caterpillar Inc.

Attachment I
Responses to Specific Questions

Questions regarding an integrated audit of the financial statements and internal control over financial reporting:

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?*

   No, we believe that if Congress intended for the external auditor to perform an "audit" of internal controls, Section 404(b) of the Sarbanes-Oxley Act ("the Act") would have been so written. In our opinion, the scope of the auditor's work was intended to be an attestation of management's assertion of the process used to evaluate the effectiveness of internal controls; not an audit of internal controls. Requiring the same level of assurance from both management and the auditor will unnecessarily require significant and duplicative work.

   In its report (Report 107-205) of major provisions of the Act, The Committee on Banking, Housing and Urban Affairs states that, "In requiring the registered public accounting firm preparing the audit report to attest to and report on management's assessment of internal controls, the Committee does not intend that the auditor's evaluation be the subject of a separate engagement or the basis for increased charges or fees." Prior to the Board's issuance of the proposed audit standard, Financial Executives International reported that, "In this new regulatory environment, companies will have to add financial staff and pay significantly higher auditing fees - projected at 20 percent to 200 percent over pre-Enron/Andersen fees."

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?*

   We believe the auditor should perform both an attestation of management's assertions regarding internal control and perform the audit of the financial statements.

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?*

   As stated in the response to question two above, we believe the same auditor should perform both an attestation of management's assertions regarding internal control and perform an audit of the financial statements.

Question regarding the costs and benefits of internal control:

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?*

   We appreciate that the Board acknowledges internal control is not "one-size-fits-all," and, to a great extent, depends on the size and complexity of the company. However, as evidenced by proposed restrictions placed on the external auditor's reliance on management, we do not believe the standard gives appropriate consideration or importance to a strong control environment ("tone-at-the-top") and sophistication and competence of management, including internal audit, which may be present in larger companies.

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.*

   No, we believe that existing attestation and audit standards provide sufficient guidance in the supervision of audit personnel. We believe that penalties to audit firms provide sufficient incentive to ensure their personnel possess the necessary professional competencies and training to conduct attestation engagements.

Questions regarding evaluation of management's assessment:

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?*

   No. Please refer to our response to question 1. We do not believe that the auditor should provide the same level of assurance as management. We believe the collaborative effort of the external auditor, internal auditor and management provides investor the broadest, most cost-efficient assurance regarding a company's system of internal accounting controls.

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

   We believe the Board has provided an appropriate level of criteria to enable the auditor to exercise judgment in evaluating the adequacy of management's documentation.

8. *Is it appropriate to state that inadequate documentation is an internal control deficiency, the severity of which the auditor should evaluate? Or should inadequate documentation automatically rise to the level of significant deficiency or material weakness in internal control?*

   We believe the auditor should be permitted to evaluate whether the absence of documentation represents an internal control deficiency. The absence of internal control procedural documentation does not alone represent a deficiency that would lead to misstated financial statements. However, the absence of management's evidential documentation that controls are operating effectively, could call into question the validity of management's assertion. In our opinion, neither the absence of procedural documentation nor the absence of evidential documentation represent de facto evidence those internal controls are non-existent or ineffective.

   We believe the absence of documentation represents a <u>potential</u> internal control deficiency that the auditor should evaluate to determine whether the severity warrants elevation to significant deficiency or material weakness.

<u>Questions regarding obtaining an understanding of internal control over financial reporting</u>:

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

   We agree that walkthroughs are an extremely effective and necessary procedure in identifying and understanding the operation of internal controls in complex transaction systems. However, we believe the auditor should be permitted to exercise professional judgment in selecting and designing audit procedures and testing strategies.

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?*

    We do not believe the external auditor should be precluded from relying on the results of walkthrough procedures conducted by others, such as a competent internal audit function or even management. In addition, paragraph 101 of the standard appears to preclude the year-to-year rotation of audit procedures. We do not agree that full, detailed walkthrough procedures be conducted annually, if the auditor is satisfied, through inquiry and validation, that process change controls and IT general controls over processes and systems are operating effectively.

<u>Question regarding testing operating effectiveness</u>:

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?*

    Again, we believe the auditor should be permitted to exercise professional judgment in determining the nature, timing and extent of audit procedures. One factor used by the auditor is the cumulative knowledge and evidence obtained in previous years.

    In addition, we believe an effective internal control framework should include process change controls. Therefore, we believe evidence of the effectiveness of controls can be efficiently obtained every year if the auditor is satisfied, through inquiry and validation testing, that process change controls and IT general controls over processes and systems are operating effectively.

<u>Questions regarding using the work of management and others</u>:

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

    We are sensitive to the need for the external auditor to maintain an "arms-length" relationship with management. However, we believe the Auditor Independence provisions of Title II of the Act will achieve the desired relationship. We believe restrictions placed on the external auditor in paragraphs 103–110 are not sensitive to the public company representative's concerns voiced at the Board's July 29 roundtable discussions. In our opinion, paragraphs 103-110 represent the most onerous provisions of the standard and will cause a significant and unnecessary duplication of effort.

    We understand the work of others should not replace the work of the external auditor, in whole or in part. Rather, we believe that the external auditor should be able to attest to management's assertion on the effectiveness of internal controls by understanding management's evaluation process through auditor testing on a sample basis and through re-performing work conducted by management and internal auditors on a sample basis.

    Furthermore, internal auditors performing their work in accordance with the Institute of Internal Auditors' Standards for the Professional Practice of Internal Auditing should be relied upon, by the external auditor, to conduct their work with competence and objectivity. Of course, we recognize the external auditor will be required to re-perform certain work of internal audit to develop a basis on which to judge the internal auditors' competence and objectivity.

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

    We believe the three categories outlined by the Board are appropriate. However, as stated in our cover letter and in our response to question 12 above, we believe paragraphs 104-106 of the Standard unnecessarily restrict the external auditor's use of others' work.

    We believe the external auditor, subject to his/her professional judgment and direction, should be able to use the results of controls testing performed by internal auditors, and to a large extent, by management. For example, we believe internal audit can competently and objectively carry out audit tests of those areas specifically restricted by the standard including: fraud controls, controls over period-end financial reporting, IT general controls, walkthroughs, significant non-routine and non-systematic transactions, and controls over significant accounts where the external auditor has assessed the risk of failure as high.

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?*

    As stated in our cover letter and in responses to questions 12 and 13 above, we do not believe the standard permits enough reliance on the work performed by internal auditors and creates unnecessary duplication of work between the internal and external auditors.

    Furthermore, the monitoring component of an effective internal framework should include an internal audit function. If, through adequate re-performance of a sample of their work, the external auditor has judged the internal auditors to be competent and objective, then the external auditor should be permitted to use the work of internal auditors.

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)?*

    We agree the auditor should have the flexibility in determining the extent of reperformance of the work of others. However, consistent with our responses to questions 10-14, we believe the Standard does not permit the auditor enough latitude in applying professional judgment to the design and execution of audit procedures. We believe Congress did not intend for compliance with the Act to increase audit fees. Therefore, we believe the Standard should allow for more flexibility in reperformance.

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?*

    Again, the auditor should be permitted to exercise professional judgment in determining the evidence necessary to attest to management's assertion on the effectiveness of internal controls. It is the auditor's responsibility to evaluate the credibility of the evidence obtained. If this concept remains in the final standard, "principle evidence" should be better defined.

Questions regarding evaluating results:

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?*

    We believe that definitions are necessary. However, we believe the terms "more than remote likelihood" and "more than inconsequential in amount" significantly lower the bar for determining when and internal control deficiency is considered significant vis-à-vis existing authoritative literature – FAS 5. We see no reason for the proposed standard definitions to differ from FAS 5. Again, we believe the auditor should use professional judgment in determining whether an internal control deficiency is a reportable condition.

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?*

    We agree the examples in Appendix D are helpful in applying the definitions of material weakness and significant deficiency. However, the examples do not demonstrate how other components of the internal control framework could help to mitigate weaknesses in control activities or minimize the likelihood of significant deficiencies or material weaknesses.

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

    Yes, it is essential the auditor evaluate the severity of all identified internal control deficiencies. However, deficiencies should not be evaluated as a standalone control but rather in the context of all five components of the control framework and in relation to company-level controls and mitigating controls.

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?*

Currently, our external auditor reports internal control weaknesses noted while conducting the financial statement audit. We believe it is appropriate for the auditor to report internal control deficiencies that warrant the attention of management. However, we believe it is unnecessary for the auditor to report internal control deficiencies that management is already aware of or is addressing via remedial actions.

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

We agree that most of the matters identified by the Board represent strong indicators, but not represent de facto evidence, that a potential material weakness in internal control may exist.

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?*

We agree that an effective audit committee is an important monitoring control and is essential in maintaining an effective control environment. Accordingly, effective audit committee oversight is yet another control expected in the overall internal control framework. Therefore, in our opinion, the <u>specific requirement</u> that the external auditor evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is unnecessary.

In addition, we believe this provision could be construed a conflict of interest for the auditor. Because the audit committee is charged with oversight of the auditor, including appointment, dismissal and compensation, this conflicting interest could bias the external auditor's evaluation of the audit committee.

In addition, we believe the criteria, outlined in paragraph 57 of the standard, against which the external auditor is expected to evaluate the audit committee, are either immeasurable or already performed by the board of directors.

We believe the audit committee is best evaluated by the board of directors.

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

No. Please refer to our response to question 22. In addition, audit committee members' expertise and background is varied and broad generally well exceeding that of the auditor. Accordingly, the auditor would only be able to evaluate the audit committee on an incomplete set of criteria.

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. Please refer to our response to question 23. We do not believe the auditor is in a position to objectively evaluate the audit committee.

If the requirement of the auditor to evaluate the effectiveness of the audit committee survives the final standard, we believe the decision whether to withdrawal from the engagement should be at the auditor's discretion. Furthermore, we believe it is inappropriate to presuppose the severity of ineffective audit committee oversight as warranting withdrawal from an engagement vis-à-vis other material weaknesses.

Questions regarding forming an opinion and reporting:

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?*

Yes, we believe it is appropriate for the auditor to express an adverse opinion on the effectiveness of the company's internal controls if a material weakness exists. However, this conclusion is only appropriate if the auditor is not satisfied that other controls within the five components of the control framework have not effectively mitigated the weakness. In addition, an adverse opinion is inappropriate if management remedies the weakness before the date of management's assertion.

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

    Yes. For example, we believe that outsourcing a significant service or a material acquisition, particularly a non-U.S. company, in the fourth quarter would not allow sufficient time for management to assess, and the auditor to attest, as to the internal controls of the acquired company. In these examples, a qualified opinion would be appropriate.

27. *Do you agree with the position that when the auditor issues a non-standard opinion, such as an adverse opinion, that the auditor's opinion should speak directly to the effectiveness of the internal control over financial reporting rather than to whether management's assessment is fairly stated?*

    If the auditor concurs with management, we believe the auditor's report should refer to whether management's assessment is fairly stated. If however, the auditor does not concur with management, then the auditor's opinion should speak directly to the effectiveness of internal control over financial reporting.

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, additional guidance may be helpful.

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

    We believe the external auditor should be prohibited from designing and implementing internal controls that have a significant impact over financial reporting.

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, we believe the limited scope the auditor's responsibility related to management's quarterly certifications are appropriate. However, we believe the scope of the auditor's work should be limited to inquiry of management and review of internal audit reports. We do not believe it is practicable for the auditor to observe whether significant changes in internal control have occurred over significant accounts each quarter.

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

Please refer to our response to question 30 above. We believe the scope of the auditor's quarterly procedures should be limited to inquiry.

BRYAN CAVE

Gregory A. Billhartz
Associate
Direct (314) 259-2510
gabillhartz@bryancave.com

November 24, 2003

VIA E-MAIL AND
VIA FEDERAL EXPRESS

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

Dear Sir or Madam:

On behalf of our client, a New York Stock Exchange and Fortune 1000 company, we enclose the attached comment letter in response to 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*," proposed by the Public Company Accounting Oversight Board on October 7, 2003.

If you require any additional information, or if we can provide you with any other information, please contact me at 314-259-2510 or R. Randall Wang at 314-259-2149.

Best regards,

Gregory A. Billhartz

Enclosure

cc: R. Randall Wang

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In Association With Bryan Cave (Illinois)
Chicago

and Bryan Cave, A Multinational Partnership
London

November 24, 2003

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

Dear Sir or Madam:

Reference: PCAOB Rulemaking Docket Matter No. 008

By way of reference, I am the Controller of a New York Stock Exchange and Fortune 1000 company in the primary business of manufacturing non-durable consumer products. We operate at 29 locations within sixteen states and with separate corporate headquarters. We sell to retailers throughout the United States. We generally compete with companies who are privately owned.

In response to PCAOB Rulemaking Docket Matter No. 8—PROPOSED AUDITING STANDARD—AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS (the "Proposed Rules"), we offer the following comments:

Question 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?

Response: Although within the Proposed Rules the Board acknowledges the facts that "internal control is not 'one- size-fits-all'", and that "the Board expects that the auditor will exercise reasonable professional judgement in determining the extent of the audit of internal control and perform only those tests that are necessary to ascertain the effectiveness of the company's internal control," the Proposed Rules appear to ignore these statements. The Proposed Rules mandate the scope and level of review regardless of the characteristics of an issuer. Specifically, Question 5 asks whether the Board should specify the level of competence and training necessary to perform specified auditing procedures effectively. This question assumes a standard can be created that applies to audit procedures of all types of issuers. We submit that since auditing procedures must be tailored to the characteristics of each issuer, no standard could be developed that would have satisfactory universal application. Compliance and training must be the responsibility of, and be subject to [the discretion of], the auditing firm and should not be dictated by rule. In addition, Question 11, asks " 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?" You appear to answer your own question in a previous paragraph when you state "However, each year's audit must stand on its own. Therefore the auditor must obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year." Again, this appears to eliminate any judgment the auditing firm may have on where to spend its resources to achieve the overall goal of reporting on internal controls. In our view, the auditor should be able to determine the nature and extent of testing based upon its assessment of risks and costs/benefits. Further, it is our opinion that developing a "cookie cutter" approach to auditing internal accounting controls, where procedures, timing and materiality are specified by rulemaking bodies, will result in a false sense of security and will carry a much higher cost. In the event a rule dictates a de novo review of an issuer's controls, issuers will pay for audit work that is not necessary with respect to previously accepted controls.

Question 12—To what extent should the auditor be permitted or required to use the work of management and others?
Question 13—Are the three categories of controls and the extent to which the auditor may rely on the work of others appropriately defined?
Question 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?
Question 15—Is the flexibility in determining the extent of reperformance of the work of others appropriate, or should the auditor be specifically required to reperform a certain level of work (for example, reperform tests of all significant accounts or reperform every test performed by others that the auditor intends to use)?
Question 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?

Response—In our opinion, the answer should depend upon the judgment and work of the auditor and should not be specified by rulemaking bodies. The profession already has guidance as to when it is appropriate, and not appropriate, to rely upon the work of internal auditors. Specifically, in our own case, we have engaged an independent Big Four auditing firm to perform internal audit work. This firm operates under the direction of the Audit Committee and the Controller. If our auditors cannot use the work performed by our internal audit firm in any significant way, we would have to reconsider whether an internal audit function so designed had any benefit compared to the costs. In our view, eliminating or reducing the internal audit function would clearly be a step backward.

Question 22—Is it appropriate to require the auditors to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting?

Response - It is our opinion that the Proposed Rules will require the auditor to evaluate aspects of the audit committee for which there is no objective and measurable criteria (process used and time spent on internal control and financial reporting issues) and will require the auditor to evaluate aspects of the audit committee which the board of directors, with the assistance of the company's legal counsel, has already performed (independence of the audit committee members, financial experts, etc). In addition, it is our opinion that the requirement appears to expand the definition of internal control over financial reporting and the criteria established in "*Internal Control – Integrated Framework*" issued by The Committee of Sponsoring Organizations of the Treadway Commission. It appears that the Proposed Rules would make the auditor ultimately responsible for audit committee functions, internal controls and financial reporting. The proposed rules turn corporate governance on its head. Directors and officers are ultimately responsible for a corporation's management and financial reporting. The proposed rules alter this responsibility by mandating the audit scope, unduly limiting the use of audit work performed by others, and making auditors the ultimate evaluator of director performance.

Other issues—

Timing of Standards. Based upon the current timetable, it appears that a final standard will not be available until at least March 2004. If this is the case, it will be unlikely that our auditors can evaluate the final standards, develop a testing program and complete all tests at, as currently specified, all 29 locations prior to our fiscal year end. It is a significant, unanswered question as to whether resources exist currently in order to discharge these tasks in the time allotted. We are very concerned that this requirement will place an undue burden and cost upon our management and auditors that will ultimately be borne by our shareholders. Further, our auditor and management will be focused on the Board's final rules and their application at a time when focusing on the actual audit should be the primary concern. We believe the rules should apply to the first fiscal year following adoption unless the rules are adopted less than six months prior to the start of a fiscal year. In such a case, the rules should not apply until the next subsequent fiscal year.

Cost of Compliance. Although we concur with the goals of the Proposed Rules (improved internal controls and financial reporting), we are very concerned about the costs associated with these goals and the cost/benefit relationship. Our goal has always been to develop and maintain an internal control environment to ensure our financial statements are not only in accordance with generally accepted accounting principles, but is prepared using the most appropriate accounting principles. We have been on the forefront in stressing ethics in all behaviors and in fostering a control environment focussed on "doing the right thing" no matter what the impact on "reported earnings". However, it is our opinion that if the Proposed Rules are issued in their current form, our cost of compliance will increase dramatically. We are not in a position to routinely raise prices to cover the incremental costs. Further, because many of our competitors are privately held companies who will not be subject to these incremental costs, we will not be able to remain competitive. Accordingly, it is our opinion that we may be forced to take what may be considered drastic actions in order to reduce our costs. Such steps will reduce costs but they will only negatively impact the quality of our operations and management.

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Bruce A. Jackson Corporate Vice President, Finance
Chief Financial Officer

February 17, 2004

Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Dear Sirs:

I am the Chief Financial Officer of a NYSE listed company with revenues of approximately $510 million. We just were told by our auditors, PricewaterhouseCoopers, that they expect our audit fee to triple in 2004 because of the costs associated with Section 404 compliance. The key issue seems to be that the proposed rules do not permit auditors to use judgment or materiality considerations to focus their auditing procedures on areas of greater internal control risk. Further, they say that your rules will require them to do the work required to issue an opinion on our internal control systems, rather than an opinion on our review and testing of our internal control systems, which I believe was intended by Congress.

Our company has a long history of outstanding internal controls, and no material errors, adjustments or fraud have occurred in my 15 years here as CFO. Therefore, I cannot understand how you could be writing rules that would require my auditors, and my staff, to spend twice as much time examining our internal controls as they do examining the company's financial statements. What sense does it make for regulators to require more than two-thirds of our effort to be spent on perhaps 5% of the value that auditors deliver to shareholders?

I hope you understand and carefully consider the consequences of your rule-making on companies such as ours. We cannot afford to throw hundreds of thousands of dollars away for a huge project which has little or no value to our shareholders, just because a few large companies made some ill-advised financial reporting decisions a couple of years ago. The rules must give auditors the ability to assess risk in planning their work, and to focus their efforts only on areas or controls which could have a material effect on the company's financial statements. Further, the auditors' scope of report should address only their review of our review and testing of internal controls, and not be expanded beyond the level of work called for in Sarbanes-Oxley. Otherwise, the waste of time and money will be astronomical, without shareholders receiving any substantial benefit.

Very truly yours,

Bruce A. Jackson
Corporate Vice President-Finance
and Chief Financial Officer

COMMENTS ON THE PROPOSED AUDITING STANDARD AN AUDIT OF INTERNAL CONTROLS OVER FINANCIAL REPORTING

General Comments

This is a powerful document that should do much to deter, as well as detect the frauds and related behaviors that have been so costly to investors and have weakened confidence in the securities markets. Its strength is that it is comprehensive and definitive, and that it adds important new control features such as walkthroughs, Audit Committee oversight and attention to fraud controls.

The critical specific comments that follow are intended to improve an already strong document.

Framework Used by Management

<u>Paragraph 14 and Appendix A illustrative reports</u>

COSO and professional standards make it clear that financial reporting controls do not prevent or detect <u>indirect effects</u> on the financial statements of violations of laws and regulations or problematic operating controls. They also place limitations on the inclusion in financial reporting controls of those controls that are related to the acquisition, use and disposition of assets. The audit report should make these limitations clear to the public.

Reasonable Assurance

<u>Paragraphs 16 and 18</u>

Existing auditing standards do not state that "reasonable assurance" means "a high level of assurance". SEC Release 33-8238 does not define that term. Heretofore, the term "reasonable assurance" has been open to interpretation and a high level of assurance may not have always been sought, much less achieved.

Because management is not bound by this auditing standard, management might apply a lesser standard than "high". This potential problem should be dealt with by stating clearly that auditors will not affirm management's assessment of internal control effectiveness unless the auditor has a "a high level of assurance" that controls are effective.

<u>Paragraph 153(h) and Appendix A illustrative reports</u>

The scope paragraph should use the words "a high level of assurance" rather than "reasonable assurance".

Fraud Considerations in an Audit of Internal Control

Paragraphs 24 through 26

This standard should forge a stronger link to the fraud standards in AU 316 (or preferably SAS 99). This is needed because the fraud standard discusses control risks and those risks should be addressed early on in the audit of internal control. A minimum step would be to state that attention to the fraud risk factors mentioned might help to identify the controls to be tested and that high levels of fraud risk should increase the extent of controls testing.

It would be helpful to reference SAS 99, paragraphs 51 through 67.

Management Fraud

A separate section of the standard should deal with the internal control issues related to this pervasive cause of the financial statement restatements of recent years. Low level fraud or error is not the reason the Sarbanes Oxley Act was passed.

Under certain circumstances the auditor should intensify the auditing of controls related to the prevention or detection of management fraud and should exercise a heightened degree of professional skepticism. If the auditor has a high level of concern about management behavior, the auditor should consider whether and how to use forensic techniques to uncover management fraud.

The following are some of those circumstances:

- Weaknesses in Paragraph 24 controls point toward management
- Walkthrough discussions with company personnel have identified concerns about management, or find that control personnel are vulnerable to manipulation.
- There are unexplained discrepancies in the accounting records, unexplained conflicting or missing evidential matter, or serious problematic relationships between the auditor and management
- Unauthorized transactions involving management have occurred
- The auditor has concerns, even concerns that are intuitive, about management bias, integrity or ethics.

Authorization of Transactions

A separate section of the standard should deal with control issues related to authorization of transactions. Proper *authorization of receipts and expenditures* and *detection of unauthorized acquisition, use and disposition of assets* are imbedded in the definition of internal control.

The standard should require the auditor to consider the levels of authority appropriate for the authorization of the various types of transactions, the circumstances in which explicit authorization should be required, and the need for documentation of explicit approvals.

Examples of areas where effective authorization controls are especially important should be cited. Those include general ledger entries, transactions involving management or management compensation, changes in sales or loan terms, speculative derivative transactions, transactions subject to 8K reporting, and changes in computer systems.

Foreign Operations

Paragraph 39 or elsewhere

Mention should be made of the fact that the personnel of business units located outside the United States may sometimes lack comparable ethical standards and knowledge of US accounting standards, and therefore control risks are likely to be higher. The control and accounting requirements of the Foreign Corrupt Practices Act have not eliminated these higher risks.

Risk Assessment

Paragraph 50, 102 or elsewhere

More should be said about how:

- The auditor should use management's risk assessment
- The auditor should pursue his or her own observations about risk
- The level of risk should affect the selection of controls to be tested and the extent of testing.

There is specific guidance on identifying controls to be tested in the proposed standard. This may incorporate risk-based judgments by the draftsmen of the proposed standard. But, the auditor's judgment of risk should be another important determinant of the controls to be tested, and risk should always be considered in deciding on the extent of testing.

If risk of misstatement is a concern and control effectiveness is to be judged solely on the basis of tests of transactions, some additional guidance on the extent of testing should be included in the standard. When testing repetitive processing of transactions, the auditor should be required to sample at least enough transactions to detect, with a high level of confidence, one error if there are any errors in the process.

Audit Committee Effectiveness

Paragraph 56

The nature and extent of the relationship between the auditor and the Audit Committee enables the auditor to identify some of the conditions that indicate significant control deficiencies, but does not permit an affirmative conclusion about oversight effectiveness. This limitation should be more clearly stated. It is also necessary to state that the auditor's responsibility to investors and other users of audit reports is paramount, and that functional responsibility to the Audit Committee should not interfere with nor limit the auditor's evaluation of conditions that indicate the possibility of significant control deficiencies.

Paragraph 57

The following should be added to or integrated with the bullets in the proposed standard:

- Level of involvement with the fraud controls mentioned in Paragraph 24, especially those that the Sarbanes Oxley Act and listing standards make the Audit Committee's direct responsibility, e.g. handling complaints.
- Level of concern with the scope of audits, and the degree of follow-up on the findings and recommendations of the auditors.
- Responsiveness to issues raised by the auditors, including those required by auditing standards to be communicated to the Audit Committee
- Level of involvement in accounting for complex transactions and in reviewing related party transactions.
- Competence of Audit Committee members, i.e. all members should be at least "financially literate" as defined by the 1999 Blue Ribbon Committee and one or more members should qualify as an "audit committee financial expert" as defined by SEC rule.

Paragraph 58

While laudable in its objective, this paragraph is not sufficiently operational in its present form. More should be said about how Audit Committee members' actions indicate lack of independence. And, what is said about the process of selecting members should be modified. The comments on the process are true, but the examples suggest processes that may not always be good indicators of independence. Qualifying words are needed. Also, "friends" should be replaced by a broader statement, such as the one in the third sentence of the following paragraph.

Listing standards establish a number of rules for independence, but otherwise give the Board of Directors the responsibility for making the independence determination. If the rules are not observed, that alone may indicate a lack of independence. Not addressed by the rules are the economic and interpersonal relations between company officers and directors unconnected with their company roles that can compromise independence. Auditors may learn of these relationships and should take them into account in evaluating the independence of Audit Committee members. But these relationships, without other evidence, are not ordinarily sufficient to conclude that there is a lack of independence.

Actions of the Committee can reinforce concerns about relationships. Or, actions alone may be sufficient to conclude that there is a lack of independence. Auditors may observe that members are unduly deferential to management, and auditors are often in position to observe Audit Committee members' reactions and follow up when issues involving management arise. Especially significant is lack of concern and follow up by members to those issues where the CEO or CFO may obtain an actual or potential economic benefit and there is a hint of bias or of questionable ethics or integrity.

Paragraph 59

Significant deficiencies should be communicated in writing to the full Board of Directors.

Information Technology and its Effect on Internal Control

Paragraph 70 and elsewhere

Paragraphs 16 through 20 of AU 319 referenced in paragraph 70 describe some of the risks and other challenges an auditor faces in a computer environment. But these AU 319 paragraphs are not very helpful. Guidance elsewhere in the proposed standard indicates the importance of general controls, but doesn't deal with other control issues. Paragraph 107 appears to overstate the reliance that may be placed on general controls. Additional references should be made to AU 319.30 through .32, AU 319.68 and.69, AU 319.77 through 79, and AU 319.110.9. These paragraphs provide a better picture of the important control issues and what the auditor might do.

Because of the critical and overarching importance of IT controls in many companies, the auditor should seek to obtain a high of confidence in the design and operation of computer controls. These should normally include accounting related application controls as well as general controls. The standard should require the use of computer auditing techniques in most situations and, when complex systems are encountered, the use of experienced IT auditors to make the controls evaluation

Performing Walkthroughs and Related Documentation Requirements

Paragraphs 79 through 83, and Paragraph 145 and elsewhere

The following ideas for improvement should be addressed:

- In following the process flow the auditor will encounter computer processing. In order to understand the flow it may be necessary to reprocess the documents that the auditor is using in the walkthroughs through the computer system.
- In tracing events, the auditor will need to understand how events that should lead to accounting are first identified, and whether that identification is timely.
- The potential for collusion, falsified documentation and controls override makes management fraud and unauthorized acts the most difficult control problem facing the auditor. Questioning company control personnel is an audit tool that should not be neglected. The questions in Paragraph 81 that the auditor may ask should also include whether control personnel think the controls they administer are effective, whether they have ever questioned the authenticity of documents and approvals, and whether they have ever been asked to overlook a control violation. This kind of questioning can be a very effective test and can help the auditor to identify management fraud. If these questions are included in the standard, auditors will be more inclined to ask them and potential management objections to the questioning will be muted.

- In tracing events and transactions auditors may find that there are insufficient accounting controls in one or more areas. In which case, auditors should explore whether adequate control is established by operating or compliance controls. But, in so doing the auditor should keep in mind that these controls may operate less stringently than accounting controls. In these situations the auditor should be alert to the possibility that operating personnel may be involved in collusion and/or creation of false documentation.
- Walkthroughs will expose the auditor to the economics of the business and provide an opportunity to determine or help to determine the substance of transactions
- The walkthroughs of processes are essentially systems evaluations and systems can be complex. Some companies will use computer-assisted techniques to document transaction flows, control points and related controls, and the control improvements needed. Others may use manually prepared flow charts with similar information noted on them. The auditor may find this documentation useful as a starting point for the audit. Other companies will rely on narrative descriptions that may not be satisfactory when systems are complex. The auditor should be prepared to utilize advanced documentation techniques that show (a) the control points, control objectives and related risks, (b) the controls in place and the tests made, and (c) the findings on effectiveness.

Signing the Auditor's Report

One member of the PCAOB suggested that the audit partner and the concurring partner sign the audit report. This would strengthen the sense of responsibility of those who make the ultimate decisions on how to apply this standard. It would also help to focus legal liability for a false report. This suggestion should be adopted by PCAOB.

Donald H. Chapin, CPA
October 31, 2003

Contact information
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November 12, 2003

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1666 K Street, N.W.
Washington, DC 2006-2803

Re: PCAOB Rulemaking Docket Matter No. 008

To the Public Company Accounting Oversight Board:

We are pleased to present our comments on *Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements.*

Summary of Our Comments:

While we generally agree with most of the proposed standard, we take exception to the inference of "limited reliance" on internal audit for the internal control audit. This seems to be inconsistent with existing auditing literature, which provides for considerable reliance on internal audit for financial statement audits. We believe these elements will drive up the cost of the internal control audit, putting a substantial burden on medium-sized companies such as ours. Furthermore, we think that there is terminology in the proposed statement that needs clearer definition, and examples. Our detail comments follow.

Questions regarding an integrated audit of the financial statements and internal control over financial reporting:

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?*

   Yes.

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?*

   Yes. Given the fact the two audits are integrated with each other, there is no other practical way to perform the internal control audit.

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?

No. Would be much too costly and difficult to coordinate.

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?*

   Not entirely.

   The proposed standard is very complex and involved. Being a medium-sized company, we are very concerned that the cost of the internal control audit will be excessive (both soft and hard dollars), and will be a significant burden to comply with. We are concerned that we will be held to the "highest bar", more appropriately fit for the largest of companies, who have the staff and resources to handle each element of the standard.

   Unfortunately, Appendix E, "Special Internal Control Over Financial Reporting Considerations for Small and Medium-Sized Companies", only addresses small companies. It does not discuss or give guidance for medium-sized companies such as ours. While this may be difficult to articulate, we do recommend that the Board take this into consideration and set forth how the internal control audit might differ for a medium-sized company. It may be helpful to mention the level of documentation required and the like.

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 seems to be adequately addressed in Paragraphs 30 and 31.

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.

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

   Yes.

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?*

We believe that inadequate documentation is an internal control deficiency, the severity of which the auditor should evaluate. We can envision circumstances where the lack of documentation may not have any effect on internal controls over financial reporting.

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

Not entirely. We think the standard should mention that "walkthroughs" are often performed in connection with an audit of the financial statements, and therefore, are not always a "new" procedure for purposes of an internal control audit.

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?*

We believe that there are cases where the auditor can use (and perhaps rely on) walkthrough procedures performed by internal auditors.

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?*

We believe the proposed standard generally allows "previous years" audit evidence to be considered in the current year's audit. We suggest that the Board consider giving more specific guidance in this regard. For instance, there may be certain accounts and disclosures where the auditor knows (from the audit of the financial statements) that no changes in internal controls have taken place in the current year.

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

See responses to Questions 13 and 14.

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

No.

a. We would like to see a more precise definition of “control environment”.

b. We believe that more guidance is necessary to specifically define controls that have a “pervasive effect” on the financial statements. Paragraph 104 cites the example of information technology controls. However, we find it confusing when it is stated that “certain” information technology general controls have a pervasive affect. Our question is “which ones”?

   Lastly, auditors performing financial statement audits have usually relied on the work of internal auditors in the area of information technology general controls and other technology areas. Paragraph 104 and the example in Appendix B20-B23 suggests that auditors cannot rely on internal audit work for the internal control audit. We find it inconsistent that auditors can rely on internal audit in a pervasive area for the financial statement audit, but not for the internal control audit. We suggest that this be reconsidered. We also cannot understand why auditors have singled out information technology as an area for non-reliance.

c. Regarding Paragraph 105, we suggest that more definition be given to cases where the auditor is “limited” in using the results of testing performed by others. While we generally agree that higher risks are prevalent in (a) accounts involving significant judgments and estimates and (b) accounts where the risk of failure of controls is high, we also suggest that examples be given. In addition, we suggest that a definition be furnished for what it means to have “limited” use of testing by others in these situations.

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?*

We believe that the proposed standard does not place enough emphasis and preference on the work of internal auditors. We find a general inconsistency in the proposed standard and AU Sec. 322 “The Auditor’s Consideration of the Internal Audit Function in an Audit of Financial Statements”. The proposed standard seems to imply that reliance on the work of internal auditors should be significantly limited in audits of internal controls, whereas AU Sec. 322 permits greater reliance on internal audit in audits of financial statements. If the two audits are integrated, we believe the standards should be the same.

See our response to Question 13. We believe that Paragraph 104 of the proposed standard should not impose the requirement of non-reliance on the results of testing performed by internal audit in the 4 areas cited. As we have stated in our responses to Question 10 and 13, there may be cases where the auditor can significantly benefit and rely upon the work of internal auditors.

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)?*

    We believe that flexibility in reperformance is especially important in cases where the auditor is relying on the work of the internal auditors.

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?*

    No. We believe that existing auditing literature allows the auditor to place reliance on the work performed by internal auditors. This should be incorporated into the "benchmark".

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?*

    The definitions seem appropriate.

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 examples in Appendix D are helpful.

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

    Yes.

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?*

    No. The materiality considerations set forth in Paragraphs 21-23 cover this area adequately. To require the auditor to communicate every internal control deficiency would seem to go way beyond the spirit of the proposed standard. It would also put the auditor in the unenviable position of communicating all internal control deficiencies, including those cited by internal auditors and the like.

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

    Yes.

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?*

    Maybe. We raise the question as to whether there is an inherent conflict for the auditor, due to the fact that Audit Committee employs the auditor?

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

    Yes.

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, unless such a weakness would cause the auditor to also withdraw from the audit of the financial statements.

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?*

    Yes.

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

    Yes, Example A-3 is a good use of an “except for” opinion.

27. *Do you agree with the position that when the auditor issues a nonstandard 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?*

Yes.

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

See Question 29.

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

We believe that this is adequately covered in Paragraphs 32 – 35. However, the last sentence of Paragraph 33 seems to imply that it is acceptable for the auditor to provide internal control related non-audit services, as long as such services are approved by the Audit Committee. This seems to conflict with the spirit of the independence rules set forth in the proposed standard. We think the Board needs to be clear on this issue.

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.

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

Yes.

Cordially,

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November 21, 2003

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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

Ladies and Gentlemen:

Citigroup Inc. appreciates the opportunity to comment on the Public Company Accounting Oversight Board's (the "Board" or "PCAOB") Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements. Citigroup is supportive of the Board's efforts to establish professional standards governing the independent auditor's attestation and reporting on management's assessment of the effectiveness of internal control.

We agree with the overall objective of the proposed standard, and believe that a new auditing standard will assist a company's independent auditors in reporting on management's assessment of the effectiveness of internal control. However, as explained more fully below, we believe that certain aspects of the proposed standard should be reconsidered. In general, we believe that the standard is too prescriptive and that independent auditors must have significantly more flexibility to determine the nature and scope of their testing, including the extent of their reliance on the work of others, in order to form an opinion on the effectiveness of a company's internal controls. We are particularly troubled that the proposed standard does not adequately recognize the benefits of a strong internal audit function.

The accounting abuses which led to the Sarbanes-Oxley Act and this proposed auditing standard resulted from the breakdown of key controls over high-risk areas of financial reporting. By prescribing limits on the extent to which the auditor can use the work of management and others, the proposed standard draws the auditor's attention and resources away from areas of high audit risk to areas that, for many companies with sophisticated systems, would otherwise be deemed to represent low audit risks (e.g., internal controls related to certain routine and recurring period-end financial reporting processes).

Using the Work of Management and Others

The proposed standard prescribes certain circumstances where the independent auditor would be precluded from using the results of testing performed by management and others. These prohibitions include:

(1) Controls that are part of the control environment, including controls specifically established to prevent and detect fraud that is reasonably likely to result in material misstatement of the financial statements;

(2) Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; to initiate, record, and process journal entries in the general ledger; and to record recurring and nonrecurring adjustments to the financial statements (for example, consolidating adjustments, report combinations, and reclassifications);

(3) 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; and,

(4) The proposed auditing standard would not allow the auditor to use the work performed by management or others to satisfy the requirement to perform walkthroughs.

Additionally, the proposed standard prescribes two areas where the independent auditor's use of the results of procedures performed by management and others should be limited:

(1) Controls over significant non-routine and nonsystematic transactions (such as accounts involving significant judgments and estimates); and,

(2) Controls over significant accounts, processes or disclosures where the auditor has assessed the risk of failure of the controls to operate effectively as high.

The specific internal controls in place, the inherent risks underlying those controls, and the competency of management, internal audit and others in reviewing and testing those controls, may vary greatly from company to company. The limitations and prohibitions the proposed standard places on the use of the work of management, internal audit and others, are unduly focused on specific types of controls without regard to the risks inherent in those controls. As a result, the proposed standard requires excessive independent testing by the auditor where the inherent audit risk might be deemed low. The standard should place more emphasis on the identification of those controls that represent the greatest audit risk and focus on the independent auditor's exercise of professional judgment in assessing those controls. The proposed standard should be amended to permit the independent auditor to use the work of management and others based on their assessment of the risks being reviewed, their understanding of the control environment, and the competency of the party performing the primary work. Furthermore, the auditor should be permitted to reduce the scope of their testing in favor of the work of others in recurring audits of those controls, especially where those controls are deemed to have low inherent risk. This will promote a more effective and efficient audit, particularly for large and complex organizations.

Limitations related to routine processes

We believe that the limitations related to the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; to initiate, record, and process journal entries in the general ledger; and to record recurring and nonrecurring adjustments to the financial statements, are unduly restrictive. In paragraph 106, the proposed standard supports the independent auditor's use of the work of management and others to assess controls over the routine processing of significant accounts and disclosures, without specific limitation. For a company with sophisticated systems, the controls over the period-end financial reporting process are basic and routine and we believe that the limitations on the independent auditor's use of the work of management and others are contradictory to the guidance in paragraph 106. These controls are extensively reviewed, monitored and tested by management and internal audit. The blanket limitations related to the routine processes noted above will result in an excessive amount of work for the independent auditor in areas where it would be more sensible and efficient to use the work of others. We believe that the independent auditor should have full discretion in terms of their use of the work of others in these areas, particularly where the inherent audit risks are deemed low.

Limitations related to non-routine and non-systematic transactions

We believe that the limitation related to significant non-routine and nonsystematic transactions (such as accounts involving significant judgments and estimates) is too restrictive. Such controls could encompass a broad spectrum of activities with varying levels of audit risk. Certainly, the audit risks inherent in many such controls require that the auditor perform the primary work, but the assessment of other controls with lower audit risk should be subject to the auditor's discretion. The proposed standard indicates that the reliance on the work of management and others in such circumstances should be "limited", but there is no explanation of what "limited" means. We believe that the independent auditor should evaluate each type of transaction and, using their professional judgment, determine the scope of their work and the extent of their testing based on their knowledge of related internal controls, documentation of processes, the competence of company personnel involved and the auditor's overall familiarity with these non-routine and non-systematic transactions.

Limitation related to walkthroughs

While Citigroup supports the notion that walkthroughs are important, their extent and timing should be left to the judgment of the auditor. The proposed standard does not allow the independent auditor to use the work performed by management or others to satisfy the requirement to perform walkthroughs. Walkthroughs are described as encompassing the entire process of initiating, recording, processing and reporting individual transactions, and controls for all five internal control components and fraud. We believe that this limitation is too broad in scope and that it will lead to the independent auditor's duplicating the work of internal audit in many cases. The limitation also fails to recognize that where certain processes are static it is not efficient or cost effective to prohibit using the work of management and others. In a large and complex organization, this limitation will place an overwhelming burden on the auditor that will draw their resources away from addressing more substantive issues where the audit risk is greater. We believe that the independent auditor should be permitted to use their professional judgment in determining where it is appropriate to use the work of internal audit and others to complete a walkthrough of controls. At the very least, the standard should permit the auditor to rotate its walkthrough testing, alternating with the internal auditor, so that the auditor can focus on areas of change and higher risk.

Limitations related to the work of internal audit

We are particularly troubled that the proposed standard does not adequately recognize the benefits of a strong internal audit function. The independent auditor should be able to place considerable reliance on the work of internal auditors if internal audit is sufficiently independent of management, has a strong reporting relationship directly with the audit committee and performs appropriate tests of controls. In a large and complex multi-national company such as Citigroup, the internal audit function performs a critical role in assessing the company's internal controls. At Citigroup, the internal audit group includes more than 700 professional audit staff who perform an independent and objective review of the Company's operations and procedures and report their findings to management and the audit committee. Their work includes a rigorous assessment of the Company's risk and control environment through the evaluation of financial, operational, and administrative controls; risk management practices; and adherence with laws, regulations and company policies. During 2003, Citigroup's internal audit group is expected to spend approximately 1,000,000 hours performing their work, including approximately 175,000 hours reviewing and testing technology operations with the majority covering information technology general controls. The internal audit function is independent of management and reports directly to the audit committee. Internal audit has no authority or responsibility for the activities it audits. Additionally, they neither develop nor install systems or procedures, prepare records, or engage in any other activity that would normally be audited.

As noted above, the independent auditors are limited from using the work of internal audit with respect to walkthroughs and in the assessment of certain important processes including the assessment of controls over the period-end financial reporting process, over procedures used to enter transaction totals into the general ledger; to initiate, record, and process journal entries in the general ledger; and to record recurring and nonrecurring adjustments to the financial statements. These functions are generally not where audit risk lies. The proposed standard also prohibits the use of the work of internal auditors in the testing of certain information technology general controls on which the operating effectiveness of other controls depends. However, in paragraph 108, the proposed standard acknowledges that, "Internal auditors would normally be expected to have greater competence with regard to internal control over financial reporting and objectivity than other company personnel. Therefore, the auditor may be able to use the results of their procedures to a greater extent than the results of procedures performed by others. This is particularly true in the case of internal auditors who follow the International Standards for the Professional Practice of Internal Auditing issued by the Institute of Internal Auditors. At companies where the importance of the internal audit function results in a high degree of competence and objectivity and their work is extensive, the auditor could use their work to the greatest extent an auditor could use the work of others."

We are very concerned that the limitations imposed by the proposed standard do not recognize the competency and objectivity of the internal audit function and the significant amount of effort this group puts forth in performing their duties. It seems irrational that our internal audit group will perform approximately 175,000 hours auditing technology operations including IT general controls, and the proposed standard would preclude the independent auditor from using that work. These limitations will only serve to marginalize the efforts of the internal audit function to the detriment of the overall control environment. In determining the extent to which they will use the work of internal audit, the independent auditor should determine whether the internal audit function is independent of management, if they are qualified to do the work and whether the scope of their testing is adequate. Regardless of the work done by the independent auditor, management will continue to require internal audit's attention to these areas. This will result in a duplication of effort and significant additional cost with no real benefit. In order for management to complete its assessment of internal controls, management and internal audit are necessarily involved in the review and testing of critical areas, and we feel strongly that the independent auditors should have the flexibility to consider those efforts when determining the scope of their testing.

Requirement for the Auditor's Work to Provide the Principal Evidence for the Audit Opinion

In addition to the limitations described above, the proposed standard requires that, on an overall basis, the auditor's own work must provide the principal evidence for the audit opinion (paragraph 109). It is unclear what is meant by "principal evidence". Since internal controls may affect many individual account balances and related financial statement disclosures, it is difficult to relate the testing of a particular internal control to the either the size of an individual account balance, a particular disclosure or the financial statements taken as a whole. Moreover, when any level of reliance is placed on the work of others it may be impossible to assert that the independent auditor has met the "principal evidence" threshold. Should "principal evidence" be measured in terms of hours worked, the number of individual transactions tested, or the size of individual items tested? Should it be measured in terms of individual account balances at a point in time affected by a particular control or is it somehow measured by the risk inherent in a particular control?

We believe that it will not be possible to measure in a meaningful way the testing performed by the independent auditor against the work performed by management and others to determine whether the independent auditor's own work has provided the principal evidence for the audit opinion. This is particularly true since the independent auditor, management, internal audit and others will be assessing internal controls with varying levels of inherent risk that affect the same individual account balances. For a large, complex company such as Citigroup, we believe that achieving the level of "principal evidence" that is required by the proposed standard (regardless of how that is measured), will necessitate that the independent auditor perform an unreasonable amount of testing in light of the extensive work performed by the internal audit group and management. At a high level, the concept of "principal evidence" may be relevant to the question of whether to base the opinion in part on the report of another auditor, but is not operable in respect of the interrelated controls that may be tested by both the auditor and others. We believe that the requirement that the independent auditor's own work provide the principal evidence for the audit opinion should be removed from the standard as it is inoperable and is likely to cause considerable confusion. The primary consideration should be whether the overall scope and nature of the work performed supports the audit opinion, and we believe the standard provides sufficient guidance for the independent auditor to plan and perform the audit to obtain reasonable assurance about the effectiveness of internal control without the "principal evidence" requirement.

Use of a Service Auditor's Report

The proposed standard directs an auditor to determine whether management has evaluated the operating effectiveness of controls based on procedures sufficient to assess their operating effectiveness. Such procedures include the use of a service auditor's report. However, the proposed standard does not provide adequate guidance with respect to which service auditor reports are required and how often the reports should be obtained. With respect to financial statement audit reports, SAS 70 provides guidance as to the level of review and the types of service organizations that should be reviewed during an audit of financial statements. 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 adopt similar guidance, as we believe that concepts of materiality of the controls related to service organizations and "facts and circumstances" determinations are appropriate to promote efficient and effective audits of internal control. We believe that an auditor should be permitted to limit his or her review to those service organizations providing services likely to have a material impact on the financial statements.

Furthermore, in the case of service organizations located where U.S. auditing standards are not applied, SAS 70 reports may not be available. We believe the Board should permit the use of comparable reports under non-U.S. generally accepted auditing standards.

Definitions of "Significant Deficiency" and "Material Weakness"

The Board is likely to receive many comments on the proposed standard's definitions of "significant deficiency" and "material weakness" because these definitions represent a lower threshold for reporting internal control deficiencies than the current definitions established in AU §325. These definitions are critical not only because of the reporting requirements they carry, but also because of the resources a company must employ to implement corrective action. As discussed in more detail below, we believe the proposed thresholds for identifying a significant deficiency and a material weakness are too low and this will cause management and the audit committee to focus limited company resources on issues that represent lower risks to financial reporting and may otherwise be sufficiently mitigated by compensating controls.

The proposed standard states that an internal control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A "significant deficiency" is defined as an internal control deficiency (or a combination of internal control deficiencies) that, by itself or in combination with other internal control deficiencies, results in **more than a remote likelihood** that a misstatement of the company's annual or interim financial statements that is **more than inconsequential in amount** will not be prevented or detected. We believe that the threshold for identifying a significant deficiency is too low. Clearly the Board did not intend that every internal control deficiency should be considered a significant deficiency, however, we see very little space between the two. In practical terms, it will be very difficult to assert that any internal control deficiency does not meet the "more than a remote likelihood" and "more than inconsequential in amount" thresholds.

We would agree that management should address all internal control deficiencies. However, we are concerned the definitions as proposed present such a low threshold that management and the auditor may report items to the audit committee that are not indicators of "significant deficiencies", but are more recommendations of best practices or deficiencies that are otherwise sufficiently mitigated by compensating controls. In a large and complex organization with worldwide operations and multiple product offerings, certain internal control deficiencies that in the opinion of management and the auditors do not present a significant risk to the consolidated company will nonetheless be reported as "significant deficiencies". We believe that it will be more effective to provide a greater distinction between internal control deficiencies and significant deficiencies so that senior management and the audit committee can focus resources on those issues that warrant more attention. With this in mind, we suggest the Board consider adopting a threshold for identifying significant deficiencies that is at least “reasonably possible” as described in FAS 5.

The PCAOB has introduced the term “more than inconsequential” in the definition of a significant deficiency. We believe this is a new term in accounting literature and, as such, the proposed standard should provide guidance on how to determine if an amount is “more than inconsequential”. In order to ensure that the audit committee’s attention and company resources are focused on the most important internal control issues, we suggest that the Board adopt a definition such as “significant, but less than material”.

We are also concerned that the definition of a “material weakness” is inconsistent with the definition of that term under the SEC’s final rules relating to management’s assessment of the effectiveness of internal control over financial reporting. The SEC’s Section 404 Release refers to SAS 60 when defining a “material weakness”. The SEC’s Release states, “a "material weakness" is defined in Statement on Auditing Standards No. 60 (codified in Codification of Statements on Auditing Standards AU §325) as 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 errors 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.” In contrast, the proposed standard defines a “material weakness” as “a significant deficiency that, by itself, or in combination with other significant deficiencies, results in a more than a **remote likelihood** that a material misstatement of the annual or interim financial statements will not be prevented or detected.” The difference between a “remote likelihood” and a “relatively low level” creates the possibility that there could be a difference in the application of the final auditing standard and the SEC’s Release. We believe that the definition in the proposed standard will be difficult to reconcile with the definition in the SEC’s Release. Accordingly, we believe that the proposed standard should adopt the existing AU §325 definitions of a material weakness and a significant deficiency (reportable weakness).

Identifying Significant Deficiencies

The proposed standard provides a list of certain circumstances that should be regarded as at least a significant deficiency in internal control and strong indicators that a material weakness in internal control exists. As indicated in paragraph 126 of the proposed standard, such circumstances include:

- Restatement of previously issued financial statements to reflect the correction of a misstatement.
- Identification by the auditor of a material misstatement in financial statements in the current period that was not initially identified by the company's internal control over financial reporting. (This is still a strong indicator of a material weakness even if management subsequently corrects the misstatement.)
- Oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective. (Paragraphs 56 through 59 present factors to evaluate when determining whether the audit committee is ineffective.)
- For larger, more complex entities, the internal audit function or the risk assessment function is ineffective.

- For complex entities in highly regulated industries, an ineffective regulatory compliance function.
- Identification of fraud of any magnitude on the part of senior management.
- Significant deficiencies that have been communicated to management and the audit committee remain uncorrected after some reasonable period of time.

We believe that it is not appropriate to include such a list in the final standard. This list may be intended to create a bright-line standard for identifying significant deficiencies, but, in practice, we believe it will force the reporting of certain issues that do not rise to the level of a significant deficiency in the opinion of management and the independent auditor. Certain items on the list are vague and could be subject to a broad interpretation. For example, several of the items use the term "ineffective" which is not adequately defined in the proposed standard. We agree that the items on this list could easily rise to the level of a significant deficiency and even a material weakness. However, since the circumstances surrounding any of the items on this list and the potential impact on the internal control environment will vary for every company, we believe it is not appropriate to create such a bright-line for reporting significant deficiencies. We feel that the final standard should not include any specific list of deficiencies, significant deficiencies or material weaknesses.

Consideration of Regulatory Compliance in the Assessment of Internal Control

The proposed standard states that the operations and 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. Where a company operates in highly regulated industries as Citigroup does, the consideration of compliance includes many areas that are directly related to financial reporting and many areas that are not. For example, sales practices, privacy standards, staff licensing requirements, and trade supervision are important areas of regulatory compliance, but they are not directly related to financial reporting. While such areas may be subject to review under other laws and regulations, we believe that these areas of regulatory compliance that are not directly related to financial reporting should be outside the scope of the proposed standard. Paragraph 126 of the proposed standard is written very broadly, indicating that for complex entities in highly regulated industries, an ineffective regulatory compliance function would be regarded as at least a significant internal control deficiency. We are concerned that this paragraph does not distinguish those areas of regulatory compliance that relate to financial reporting from the areas that do not. As written, this paragraph seems to imply that the independent auditor is required to perform an assessment of controls that are not directly related to financial reporting. There is no such requirement under the SEC's Release or this proposed standard and the auditor might not be in a position to determine if controls unrelated to financial reporting are effective. Notwithstanding our comment above regarding the list of significant deficiencies in paragraph 126, we recommend that the standard be amended to clarify that only regulatory compliance directly related to financial reporting is within the scope of the standard.

Reporting of "Except For" Conclusions

The Board has asked whether there are circumstances where a qualified "except for" conclusion would be appropriate. As the Board noted, the SEC's final rules implementing Section 404 state, "Management is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting." We do not believe this precludes an "except for" conclusion.

There are certain circumstances where management and the independent auditor will not have an opportunity to assess the internal controls of a part of a company, particularly with respect to acquisitions that take place close to the reporting date. This will be a particular issue in acquisitions of certain non-public US companies and foreign companies that have not been subject to the requirements of Section 404. We believe that the inability to assess the internal control environment of a recently acquired business is not, by itself, indicative of a significant deficiency or a material weakness in internal control. In such circumstances, management should be permitted a reasonable amount of time, given the size and complexity of the acquired business, to assess the internal controls of the acquired company and the independent auditor should be permitted to issue an opinion that is "except for" the acquired business.

Audit Committee Pre-Approval of Internal Control-Related Services

The proposed standard expands the SEC's auditor independence rules related to pre-approval of non-audit services by requiring that any non-audit service related to internal control be specifically pre-approved by the audit committee, rather than being pre-approved as part of a category of non-audit services related to internal control.

The audits of internal control, in many cases, are required by regulators in the U.S. and overseas. In a large complex organization, there can be hundreds of such reviews required each year. The audits are normally part of the financial statement audit, or a separate engagement specifically for the purpose of issuing an opinion on the effectiveness of the internal control environment (FDICIA or SAS 70 reviews are two examples). To require the pre-approval of the audit committee for each and every internal control review would place undue burden on the audit committee. A specifically pre-approved limit for these type of reviews delegated to senior management would be more appropriate.

Documentation Standards

The proposed standard in paragraph 43 defines the standards for the external auditor to determine whether management's documentation provides reasonable support for its assessment of internal control effectiveness. The standard would dictate the exact items that the auditor would look for including:

- Design of controls over relevant assertions related to all significant accounts and disclosures in the financial statements, including all five components in paragraph 50.
- Information about how significant transactions are initiated, recorded, processed, and reported.
- Enough information about the flow of transactions to identify where material misstatements due to error or fraud could occur.
- Controls designed to prevent or detect fraud, including who performs the controls and the related segregation of duties.
- Controls over the safeguarding of assets.
- The results of management's testing and evaluation.

We believe that the requirement to include all five components of internal control as part of the individual documentation related to “all significant accounts and disclosures” is unduly prescriptive and will add tremendous burden to management’s assessment. While we support the need to document the five components of internal control as stated in paragraph 50, this can be done at a business level, or company level, and should not be required at an individual control level. We believe that paragraph 44, which allows for many forms of documentation and requires no one specific form of documentation, is the right standard that the PCAOB should adopt. Any list in paragraph 43 should include language stating that the items on the list are examples, and are not required at the individual control level. Alternatively, the list should be deleted and included as an appendix of examples. We are also concerned with the use of language such as “enough information” leaves this open to interpretation and should be deleted.

Overall, the level of documentation should be a matter of judgment depending on the level of complexity of the organization, size, systems etc., and no one approach to documentation should be prescribed.

Report Date

The proposed standard indicates that the independent auditor cannot audit internal control without also auditing the financial statements. As a technical matter, we do not believe that this requirement should preclude the independent auditor from issuing their report on internal controls at a date subsequent to the financial statement audit report date.

The proposed standard indicates that an auditor could issue an updated report on internal controls in response to the subsequent discovery of information existing at the date of their original report on internal controls if such information would have affected their internal control opinion (see paragraph 180). If the information leading to an updated internal control report does not impact the original financial statement audit opinion, this could create a situation where the revised internal control report and the audit report would have different dates. While we expect that the internal control report and the financial statement report will have the same date because the work on both will coincide, we believe it is more appropriate to tie the date of the internal control report to the completion of the fieldwork related to the assessment internal controls. Ultimately the dates on both reports will be driven by the underlying requirement for the reports (e.g., the requirement to file a certification with the SEC or the issuance of the financial statements). As a technical matter, we believe that the proposed standard should be amended to remove the requirement that the two opinions share the same date.

Conclusion

Citigroup is appreciative of the opportunity to comment on the proposed auditing standard and we thank you for considering our comments. If you have any questions regarding this letter, please contact me at your convenience.

Sincerely,

William P. Hannon
Controller

Commercial Federal Bank

November 21, 2003

Office of the Secretary
PCAOB
1666 K Street, N. W.
Washington, D.C. 20006-2803

RE: PCAOB Rulemaking Docket No. 008

Dear Sir or Madam:

Commercial Federal Corporation (CFC) welcomes the opportunity to comment on the PCAOB's proposed auditing standard "An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements," as referred to in Section 404(b) of the Sarbanes-Oxley Act of 2002 (SOX). This comment letter is in direct response to the PCAOB Rulemaking Docket Matter No. 008.

CFC's primary subsidiary is Commercial Federal Bank (CFB). CFB is a $13 billion federal savings bank, headquartered in Omaha, Nebraska, and regulated by the Office of Thrift Supervision. CFB operates 192 branches across seven states, including Arizona, Colorado, Iowa, Kansas, Missouri, Nebraska, and Oklahoma. CFB has been subject to the provision of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) since its inception. And, specifically as it relates to SOX Section 404, FDICIA Section 112 since 1993.

We applaud the efforts of the PCAOB (the Board) as a major contributor to the landscape of enhanced governance and accountability investors rightfully expect. The Board's efforts to help restore credibility to integrity of corporate America's financial reporting processes and improve the associated oversight provided by the public accounting profession is definitely warranted. However, although we are all disheartened by the highly visible corporate misdeeds that resulted in the Sarbanes-Oxley legislation, we must also remember that overlaying excess burden and cost on the infrastructure of corporate America penalizes no one other than consumers and shareholders in the long-run. While good controls are, and should always be, cost-effective over the long-term, unnecessary and excessive validation, verification and duplication is cost-prohibitive and not in anyone's best interests. Caution should be exercised before we fully chastise the many by the misdeeds of the few through unnecessarily and onerous rules. Maybe unfortunately, but realistically, we cannot legislate, regulate or standard set corporate misfeasance and malfeasance out of existence. And, in an era of increasingly complex and evolving accounting rules, unintended restatements of financial results will undoubtedly continue.

The most troubling aspects of the proposal revolve around:

- the unwarranted and over-reaching transformation of the **attestation** of management's assessment of the effectiveness of internal control over financial reporting to an **audit** of internal control over financial reporting,
- the presumption that because there may have been some isolated instances of over-reliance on the work of others for banks under FDICIA results in a virtual elimination of any substantive reliance, and
- the inherent conflict of interest that gets created by having the auditors evaluate the audit committee.

The proposed standard solicits commentary on 31 specific questions. Contained below are our thoughts on those that we respectfully request the Board to revisit and/or reconsider:

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?

   Response to Question 1:
   The words in SOX Sections 103 and 404 require the auditor to "present an evaluation," "provide reasonable assurance," "contain an assessment of the effectiveness," and "attest to, and report on." A review of most any widely recognized dictionary will draw a distinction between an "audit" and an "attestation." An attest engagement has traditionally been distinguished from an audit. Congressional intent seems to be that an attestation be performed, not an audit. Furthermore, this is what was also the intent of FDICIA and, as has been often quoted, the intent of SOX in this context was to closely mirror FDICIA. And, lastly, even the SEC recently signaled this distinction in its implementing release on SOX Section 404 by referring to the auditor's report on management's assessment as an attestation report (not an audit report) which is to be made in accordance with standards for attestation engagements. Therefore, we believe that the guidance should not outline how to perform an audit of controls, but rather should be implementing congressional intent by focusing on how to properly evaluate management's assertion. If the Board does not consider revision of the standard and extend the opportunity for the auditor to perform a more measured and appropriate assessment of the process leading to management's assertion, whereby greater reliance can be placed on the work of others, then the auditor's extensive work/testing as outlined in the proposal ("control environment" controls, "period-end" controls, information technology "general controls, walkthroughs, significant nonroutine transactions, significant accounts, etc.) does become an audit.

4. Does the Board's proposed standard give appropriate consideration to how internal control is implemented in, and how the audit of internal control over financial reporting should be conducted at, small and medium-sized issuers?

   Response to Question 4:
   The issue is more of complexity, level of centralization, sophistication and amount of outsourcing, than solely an issue of size. How an auditor determines what the key controls over financial reporting are, and limiting the work to solely key controls, will be the primary factor. Where these key controls resultantly reside (centrally or decentrally, nationally or internationally, inside the company or outsourced, etc.) drives the complexity of the auditors work. The proposed standards suggests that "For a smaller, less complex company, the Board expects that the auditor will exercise reasonable judgment in determining the extent of the audit of internal control and perform only those tests that

are necessary to ascertain the effectiveness of the company's internal control." Is that not the case regardless of the size or complexity? Shouldn't the auditor exercise the same judgment taking into account all factors at <u>any company</u>?

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?

<u>Response to Question 8:</u>
If management's documentation of the design of the internal controls and/or management's documentation supporting their assessment of internal control effectiveness is deemed to be inadequate by the auditor, that alone should not result in a de facto significant deficiency or material weakness. If adequate controls exist and the auditor can validate or otherwise determine such existence, even in the absence of adequate documentation, then there may not be a significant deficiency or material weakness. However, if due to the inadequacy of documentation, the control cannot be validated or otherwise determined to exist, then the facts and circumstances should drive whether there is a significant deficiency or material weakness. In coming to this conclusion, we need to be sure we are remembering the audience we are communicating to and what they want and/or need to know. We must also remember that the proposed standard suggests that a repeat significant deficiency would rise to the level of material weakness in a subsequent period if not cured in a reasonable time. Does an investor, reading management's assertion in concert with the auditor's attestation report, need or ever really care to know that there was a control documentation concern but otherwise the "financial results are fairly presented in all material respects?" Unless the documentation inadequacy would result in more than a remote possibility of material misstatement, does this really add any valuable information for the investing public? (See response to question #17 regarding the definition of significant deficiency.)

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?

<u>Response to Question 10:</u>
Walkthroughs are certainly a valid and legitimate audit evidence gathering technique, and judiciously applied, can be useful in testing a process and the associated controls. The auditor should determine what financial statement accounts and disclosures are worthy of testing by the use of a walkthrough technique, but there should be certain facts and circumstances where reliance on the work of others can be deemed to be acceptable. For instance, if a company's internal audit function had completed walkthroughs, and that internal audit function's work is determined to be independent and reliable, the auditor should first conduct selected reperformance tests. Assuming the internal auditor's work is assessed as reliable, then the auditor should be able to accept the remainder of the internal auditors walkthrough evaluation without performing any further work on his or her own. Completely dismissing the work of others in this instance, however, seems to be an unnecessary and overly burdensome (and cost ineffective) stance.

Importantly, however, walkthroughs are not always necessary. The focus should be on testing how management made their assessments, and performing tests as required to gain assurance regarding management's assessment process and the associated conclusions. These tests may or may not require the extensive walkthroughs currently specified in the proposed standard.

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?

Response to Question 11:
We do not believe the concept of rotation of testing or evaluation makes inherent sense. If each year's management assertion and auditor attestation needs to stand on its own for the fiscal year being reported on, then each key control should be evaluated annually. To entertain the concept of rotation would call into question whether the controls being evaluated were key or critical controls, rather than supporting or secondary controls. The evaluation should only concern itself with key or critical controls that could, in their absence or failure, result in the potential for material financial reporting errors or restatements.

12. To what extent should the auditor be permitted or required to use the work of management and others?
13. Are the three categories of controls and the extent to which the auditor may rely on the work of others appropriately defined?
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?
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)?
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?

Response to Questions 12, 13, 14, 15, 16:
The proposed standard defines three categories of controls and the extent to which the auditor may use the work of others for each category. These categories result in either a conclusion of "no reliance," "limited reliance," or "no limitations on reliance." However, the proposed standard also goes on to state that the auditor's own work must provide the principal evidence for the audit opinion. The interplay of these principles seems to result in very little reliance on the work of others in most any area of potential materiality. Even though there are no specific limitations on reliance on the work of others in areas of routine processing of significant accounts, how does the work become the principal evidence for the audit opinion without extensive independent work by the auditor or extensive reperformance work? The proposal seems to be building in a lot of redundant cost by not allowing greater reliance on the work of others. Once the auditor is done with:

- personally testing and evaluating all significant control environment controls,
- personally testing and evaluating all significant period-end financial reporting controls,
- personally testing and evaluating all significant pervasive controls (e.g., information technology general controls),
- personally conducting all necessary walkthroughs,
- personally assessing in some manner all controls over significant nonroutine and nonsystematic transactions, and

- personally assessing in some manner all significant accounts, processes, or disclosures,

what is there left to do of a material nature?

A highly qualified, competent, and independent internal audit function, duly assessed as such by the auditor, should result in a comfort level on the work they perform. This should, in turn, allow for a much greater reliance on the work of that internal audit function than the standard currently proposes. Acknowledging this in the standard will signal what is already true: the work of a competent and objective internal audit function is cost effective and can be relied upon to a great extent.

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?

Response to Question 17:
The proposed standard's definition for significant deficiency is problematic. The determination of the deficiency as significant needs to be based on a multitude of factors beyond just the interpretation of the interplay of the concepts of "remote" and "inconsequential." Under the current proposal, any control weakness which could potentially (not actually) result in an error that is not inconsequential, would result in a significant deficiency. What does inconsequential mean? The dictionary defines it as "not relevant" or "of no importance." It seems that the threshold is set too low for "significance" -- anything that is more than not relevant or beyond no importance? The category of significant weakness should only include those weaknesses with enough importance to warrant the attention of the audit committee.

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

Response to Questions 22, 23, 24:
No, it is not appropriate for the auditor to evaluate the effectiveness of the audit committee in any formalized manner. The auditor is hired, retained, fired, and the fees approved by the audit committee. Directly evaluating the hand that feeds you results in an inherent conflict of interest that is unacceptable. Of course, if the auditor determines that there are opportunities for the audit committee to improve or enhance their practices and/or processes based on their interactions with the company or the committee, the auditor has a professional responsibility to share those conclusions appropriately (with management, the audit committee, and/or the board of directors). However, mandating and formalizing such review, creates a conflict of interest that is not much different than the perceived (and actual?) conflicts the "independence" rules are trying to eradicate. A more practical conclusion may be to expect that the board's governance committee (or in the absence of such a committee, the full board) conduct/lead this evaluation. The governance committee of the board is part of the NYSE governance rules that will become effective in 2004.

If the Board does not reconsider this position (auditor evaluation of the audit committee), then question 24 comes into play. Although the audit committee has a significant role in setting the tone at the top of an organization, the management of the company has an even larger and more pervasive role in establishing and maintaining that tone. Although an ineffective audit committee might certainly result in a concern, that concern needs to be evaluated considering the situation in its entirety. If management has established and maintained an effective system of controls over financial reporting, yet the audit committee is deemed as "ineffective," that should not necessarily result in a material weakness. **Unless,** however, the ineffectiveness is considered to potentially result in more than a remote likelihood that a material misstatement would not be prevented or detected.

28. Should the Board provide specific guidance on independence and internal control-related non-audit services in the context of this proposed standard?
29. Are there any specific internal control-related non-audit services the auditor should be prohibited from providing to an audit client?

Response to Questions 28, 29:
Although there may very well be opportunities to further study and refine the prohibitions on non-audit services that may impair or impede independence of the auditor, we would suggest allowing some time for the existing standards to settle-in before revisiting this topic.

If you have any questions or would like to discuss the comments provided above, I can be reached by telephone at (402) 827-2538 or by e-mail at HalGaryn@CommercialFed.com.

Regards,

Hal A. Garyn
Senior Vice President – Director of Audit and Risk Services
Commercial Federal Corporation

COMMONWEALTH *of* VIRGINIA

Auditor of Public Accounts

WALTER J. KUCHARSKI
AUDITOR

POST OFFICE BOX 1295
RICHMOND, VIRGINIA 23218
(804) 225-3350

November 18, 2003

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

Subject: PCAOB Rulemaking Docket Matter No. 008

Dear Sirs:

We appreciate the opportunity to respond to the Public Company Accounting Oversight Board (PCAOB) Proposed Auditing Standard *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements.*

We have provided a response to the issues/questions provided in the exposure draft, which includes several issues we would like to encourage the Board to consider when finalizing the standard.

Issue 1:

We agree with referring 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.

Issue 2:

We believe that the auditor should **not** be prohibited from performing an audit of internal control over financial reporting without also performing an audit of the financial statements. A company may desire to contract for such an audit in order to identify and correct internal control deficiencies. We see no need to prohibit that, as long as the auditor who performs the financial statement audit also performs an audit of internal controls. Perhaps the Board anticipates an auditor could do an internal control examination under AICPA Attestation Standards which would not require a concurrent audit of the financial statements in order to meet the company's needs.

Issue 3:

We believe that the work performed for internal controls should also be used for the purpose of expressing an opinion on the financial statements so long as the same auditor has performed both

Office of the Secretary
Public Company Accounting Oversight Board
November 18, 2003
Page 2

audits. The internal control audit should supplement the financial statement audit, not the other way around. We do not see the purpose of performing work comparable to that required to complete the financial statement audit because we do not understand why you would not want to issue statements if you have done that level of work. Also, see the comments at issue 2 for further details.

Issue 4:

We believe that there isn't a difference between small or larger companies when expressing an opinion on or auditing internal controls since you still have to have controls for each assertion. In addition, we do not see in the standard itself where the Board sets forth its expectation that "the auditor will exercise reasonable professional judgment in determining the extent of the audit of internal control and perform only those tests that are necessary to ascertain the effectiveness of the company's internal control." (This quotation is from the paragraph immediately preceding Question 4 in the lead-in to the proposed standard.)

Issue 5:

We do not believe that the board should dictate a specific level of competency. We are comfortable with the guidance as set forth in the proposed standard as it seems consistent with the current field work standards. The Board needs to leave some leeway for the exercise of professional judgment.

Issue 6:

We agree with the scope of the audit. The auditor should have to directly obtain evidence about whether internal control over financial reporting is effective. However, we do not believe the standard is clear about what the auditor would do in a situation in which management believes that because of budget constraints or other reasons, it is not cost effective to implement a control and the auditor disagrees or in a situation in which management has not assessed certain controls that they feel are not critical but the auditor feels are critical.

Issue 7:

Yes, we agree.

Issue 8:

We agree that it is appropriate to state that inadequate documentation is an internal control deficiency and the auditor should evaluate the severity. We therefore disagree that inadequate documentation should automatically rise to the level of significant deficiency or material weakness in internal control.

Issue 9:

We agree if the term "walkthroughs" is used in the traditional sense of physical observation and verification of the flow of documents. However, in an automated environment, a "walkthrough" may be difficult, if not impossible, to perform so there should be the opportunity for the auditor to achieve the same objectives using alternative approaches when necessary.

Issue 10:

We disagree. We believe that the walkthrough should not be required to be performed by the auditor him or herself. We believe that if the internal auditor is qualified and independent, the use of this internal audit documentation should be sufficient and reliable but only after verification. The use of a management walkthrough should never be used.

Issue 11:

To require the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year seems to be excessive and unnecessary. There should be an annual evaluation of risk and a documented cycle of rotation where evidence on the controls are obtained during the agreed upon cycle or whenever significant changes occur.

Issue 12:

The auditor should be permitted and **not** required to use the work of others. The auditor should have the flexibility to use auditor judgment when it pertains to the work of others. The Board should expand or provide more detail on its reference to the auditor using the work of management.

Issue 13:

Yes, they are appropriately defined.

Issue 14:

At times, the proposed standard does not give the appropriate recognition to the work of internal auditors. The internal auditor is prohibited from performing walkthroughs that are relied on by external auditors. We believe this is a situation that should be allowed, based on the external auditor's judgment.

Issue 15:

We believe that the flexibility in determining the extent of reliance of the work of others is important. We believe that to the extent that the auditor can reasonably verify the independence of others performing the work, it is not necessary to re-perform or perform additional work as long as the results satisfy the auditor's objectives.

Issue 16:

Yes, we agree.

Issue 17:

The definitions are subjective so we do not believe they will necessarily result in increased consistency in the evaluation of deficiencies; however, we have no suggestions to correct this inherent problem.

Issue 18:

Yes, we agree that the examples in Appendix D are helpful and don't have any other specific examples that would provide further interpretive help.

Issue 19:

No, we don't believe that it is necessary for the auditor to evaluate the severity of **all** identified internal control deficiencies. We believe that whether a deficiency is evaluated should be subject to the auditor's judgment as there may be a control that the auditor is not relying on that would make the deficiency irrelevant.

Issue 20:

Yes, it is appropriate.

Issue 21:

Yes, the matters are appropriately classified.

Issue 22:

Yes, we agree the auditor should evaluate the effectiveness of the audit committee's oversight.

Issue 23:

Yes, we believe the auditors should be able to effectively carry out their responsibility.

Issue 24:

No, it is not necessary for the auditor to withdraw from the audit engagement. It is important for the users of the financial statements to have access to the adverse opinion on the effectiveness of internal control.

Issue 25:

We agree. If management says controls are not effective then it would be confusing to the reader if the auditor did not issue an adverse opinion.

Issue 26:

No, either the controls work or they don't. For example if management gives an adverse opinion, the auditor cannot give an "except for" opinion. (See question 25)

Issue 27:

We agree because by the auditor's opinion speaking directly to the effectiveness of the internal control over financial reporting it prevents confusion on part of the reader.

Issue 28:

We believe that what the Board has provided in the standard is appropriate.

Issue 29:

Yes, there should be some internal control-related non-audit services that the auditor should be prohibited from providing. As an example, GAO's Government Auditing Standards, general standards for independence—section 3.17 note f., indicates that "...certain nonaudit services impair the audit organization's ability to meet either or both of the overarching principles in paragraph 3.13 for certain types of audit work. For example, if the audit organization has been responsible for designing, developing, and/or installing the entity's accounting system or is operating the system and then performs a financial statement audit of the entity, the audit organization would clearly be in violation..."

Issue 30:

Yes, they are appropriate.

Issue 31:

Yes, it is appropriate.

We appreciate the efforts of the Board and the opportunity to provide our comments. Should you have any questions or need additional information regarding our response, please contact me or Martha Mavredes at (804) 225-3350.

Sincerely,

Walter J. Kucharski

Walter J. Kucharski
Auditor of Public Accounts

WJK:aom

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Mariel O. Donath
President & CEO

November 21, 2003

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

RE: Proposed Auditing Attestation Requirements

Dear Sir/Madam:

The Community Bankers Association of New York State* appreciates the opportunity to comment on the proposed auditing standard governing the attestation and reporting of management's assessment of the effectiveness of internal controls. We believe that Section 404 of the Sarbanes-Oxley Act of 2002 was intended to impose similar requirements on general corporations that already exist for financial institutions under the Federal Deposit Improvement Act (FDICIA) of 1991. This law requires management of depository institutions with assets over $500 million to attest to the effectiveness of the institution's internal control structure. The institution's auditor then attests to management's assessment, but does not require another independent audit of the internal controls.

We strongly believe that the proposed new standard would add burdensome, expensive, and overlapping requirements on community banks. Furthermore, we believe that the new standard should conform to the previous requirement already mandated by Congress, or should provide an exemption for depository institutions already examined and supervised by federal banking regulators.

We respectfully request that new standards for public companies acknowledge the existing comprehensive system of regulation, examination, and supervision of insured banks and evaluate whether another layer of auditing expense is either reasonable or necessary.

Thank you for the opportunity to comment on this proposal.

Sincerely,

Mariel Donath

Mariel Donath

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* The Community Bankers Association of New York State (CBANYS) represents savings institutions and commercial banks with cumulative assets exceeding $165 billion, employing over 23,000 New Yorkers at 1,350 locations statewide, and allocating more than $1 billion annually toward local affordable housing and community development.

Computer Sciences Corporation

Leon J. Level
Vice President and Chief Financial Officer

November 21, 2003

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W., 9TH Floor
Washington, DC 20006-2803

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"

FILED ELECTRONICALLY (comments@pcaobus.org)

Dear Board Members and Staff,

Thank you for the opportunity to comment on the Public Company Accounting Oversight Board's (the "Board") proposed rule, "Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements," Release No. 2003-017 (the "Proposed Standard"), which was issued October 7, 2003. We commend the Board on its comprehensive efforts to involve all relevant constituencies in formulating this auditing standard.

We have supported the efforts of the President, Congress and the Securities and Exchange Commission to enhance investor confidence in the integrity of our financial reporting system, including legislation and regulations requiring public companies to report on the effectiveness of their internal control. Accurate and reliable financial information is fundamental to investor confidence, and effective internal control over financial reporting plays an important role in assuring the integrity of financial reporting. However, even effective internal control provides only reasonable, not absolute, assurance financial statements are not materially misstated.

While audits of internal control over financial reporting may help improve investor confidence, it is important to balance the cost of these measures with resulting benefits. The proposed audit of internal control over financial reporting certainly would not have detected or prevented the egregious fraudulent financial reporting and business failures of the past two years if full financial statement audits were not sufficient to detect or prevent these abuses.

We are gravely concerned the Proposed Standard, in fact, will result in very significant costs, wholly disproportionate to the resulting benefits. Accordingly, we think the Board should use every possible means to mitigate the cost of these measures to registrants and, ultimately, investors.

2100 East Grand Avenue
El Segundo, California 90245
310.615.0311

- We have significant concerns with the overly broad and all-encompassing nature of the proposed definition of a significant deficiency as any deficiency where the likelihood of potential misstatement is more than remote and the magnitude is more than inconsequential. Deficiencies with a potential misstatement of more than “an inconsequential amount” would encompass substantially all deficiencies. This would make it difficult to distinguish more significant deficiencies in internal control over financial reporting from matters of far less importance and those unlikely to recur.

- We also have significant concerns regarding the exhaustive scope of required audit procedures; unnecessary restrictions on reliance auditors may place on the work of management, internal audit, and others; and the prohibitively high cost of these audit procedures without commensurate benefits.

- We strongly suggest the Board reconsider proposed guidance regarding enumerated circumstances where there is a presumption each circumstance represents at least a significant deficiency and a strong indication of a material weakness.

- Finally, we think the issues requiring reconsideration are so significant and pervasive that we suggest the Board reissue the Proposed Standard upon revision for further public comment to give adequate consideration to the viewpoints of all affected constituencies.

We have provided further information regarding these concerns, as well as other significant comments, concerns and suggestions, in the following paragraphs. We also have included detailed responses in Exhibit I to the specific questions for which the Board is seeking comment.

Definition of a Significant Deficiency

We think the definition of a significant deficiency is far too broad and all encompassing. Deficiencies with a potential misstatement of more than an inconsequential amount would encompass substantially all deficiencies. This would make it difficult to distinguish more significant deficiencies in internal control over financial reporting from matters of far less importance. We also think use of such a vague threshold as “inconsequential” would result in fairly significant diversity in practice since there is no existing usage of this term in either auditing standards or generally accepted accounting principles. Furthermore, we think this definition would mandate a standard which is virtually, if not wholly, unachievable for any large, global corporation.

Scope of Required Audit Procedures and Reliance on the Work of Management, Internal Audit, and Others

Generally, we think the Proposed Standard requires an excessive scope of work for the audit of internal control over financial reporting in that it (1) mandates certain controls be evaluated directly by the auditor (2) restricts the extent of reliance which the auditor may place on procedures performed by management, internal audit, or others and (3) prohibits the auditor from relying on work performed in prior years. As a result, the Proposed Standard would result in substantial duplication of efforts as to audit procedures performed in prior years, as well as between audit procedures performed by internal auditors and the external auditor.

More specifically, the Proposed Standard requires the auditor to directly perform all procedures, and not rely upon efforts of management, internal audit, or others, in the following areas:

- Controls which are part of the control environment, such as controls designed to prevent and detect fraud;

- Controls over the period-end financial reporting process;

- Controls which have a pervasive effect on the financial statements, such as information technology general controls; and

- Walkthroughs for all of the company's significant processes.

In principle, there is simply no reason the auditor should not be able to place reliance on the efforts of others in evaluating these controls, provided the auditor has:

- Evaluated the competence, objectivity and independence of the persons performing such work (as required under Statement on Auditing Standards No. 65), and

- Reperformed such tests, or directly performed such independent tests, as are necessary to corroborate the results of such procedures.

We think these restrictions will unnecessarily materially burden the entire economy with excess cost.

The extent of reperformance and independent tests should depend upon: the results of the tests performed by others; materiality, risk of misstatement, and degree of judgment or estimation associated with the related account balance or disclosure; degree of judgment required to evaluate the operating effectiveness of the control, subjectivity of the tests, and pervasiveness of the controls. Such reliance is particularly appropriate where testing has been performed by internal audit in accordance with the Standards for Professional Practice of Internal Auditing issued by the Institute of Internal Auditors ("IIA"), and where the internal audit function is independent and objective. In fact, in most cases, the company's internal audit personnel would be at least as well qualified, and in many cases better able, to evaluate these control areas than the external auditors based on their knowledge of the company's industry, business, practices and procedures, processes and information technology systems.

Furthermore, the auditor should be able to fully rely on work of experienced internal audit personnel for controls over significant non-routine and non-systematic transactions, such as accounts involving significant judgments and estimates, where such personnel are judged to be sufficiently competent and knowledgeable, as well as objective and independent from management.

Finally, the auditor should be able to place reliance on work performed in prior years where such work is relevant to the current period. An example of this would be tests of application program controls. If such controls are tested in connection with the initial implementation of a new system it would only seem necessary to test changes in subsequent periods, assuming the auditor has tested IT general controls (including program change controls) and determined such controls are effective. This approach is referred to as "baselining" application controls and is a long established, widely accepted practice in use in audits of service providers under Statement on Auditing Standards No. 70 ("SAS 70 audits"), as well as audits of IT controls in conjunction with audits of financial statements.

Cost Benefit Considerations

Based on the various factors discussed above we think the cost of audit work required under the Proposed Standard does not appear to be reasonable in relation to the benefits to be achieved. Financial Executive International estimates potential annual audit cost increases of 30-50%. Representatives of the big four public accounting firms have indicated to us the increase could, in fact, be significantly greater – up to a multiple of the current audit fee. We think they have underestimated its impact. There will be even more substantial costs for the affected public companies. Audits of internal control over financial reporting are generally thought to result in the following benefits: improvement of public confidence in our financial reporting system and, consequently, in our capital markets, and prevention of business and financial reporting failures such as Enron and WorldCom. While we think such audits may help improve public confidence we question whether such audits will have much, if any, impact on business and financial reporting failures such as Enron and WorldCom.

Expectations Gap

In addition to the overall cost benefit disparity, we are even more concerned with the widely held misperception that audits of internal control will eliminate business and financial reporting failures. We fear this "expectations gap" may serve to further undermine our markets if, or when, we experience the next serious business and financial reporting failure. At least in part, this "expectations gap" has, in fact, resulted from unrealistic expectations created by some of the recent rule-making initiatives. For example, the chief executive and chief financial officers of registrant companies must file quarterly and annual "certifications" under Section 302 of Sarbanes-Oxley. These "certifications" address: accuracy of financial statements filed with the SEC, effectiveness of disclosure controls and procedures, and changes in internal controls that could materially affect registrant financial statements.

We strongly disagree with this nomenclature. Terms such as "certification" and "ensure" imply a much higher level of assurance than can reasonably be applied to financial information and internal controls. As previously mentioned, internal controls provide reasonable, but not absolute, assurance that financial statements are not materially misstated. Financial statements present fairly a company's financial position, results of operations and cash flows in accordance with generally accepted accounting principles. These are not absolute standards. "Management certification" is far too strong a characterization. "Management representation" would more appropriately convey the degree of assurance investors should attach to such statements. It is precisely this type of rule making that widens, rather than narrows, the "expectations gap."

Evaluating the Effectiveness of the Audit Committee's Oversight of The Company's External Financial Reporting and Internal Control Over Financial Reporting

We think requiring the auditor to evaluate the effectiveness of the company's audit committee creates an inherent serious conflict of interests in view of the committee's responsibility for appointing the auditor. Additionally, it may also serve to further undermine effective relationships among the company's board of directors, audit committee, management and external auditor. We think it is appropriate for the auditor to consider performance of the audit committee in evaluating the company's control environment. However, we do not think it would be practical to require an evaluation of audit committee effectiveness in view of the inherent conflict.

Circumstances Regarded as at Least a Significant Deficiency and Strong Indicator of a Material Weakness

We do not think the following circumstances warrant the presumption it "should be regarded as at least a significant deficiency and is a strong indicator a material weakness exists" without further evaluation of all the relevant facts and circumstances:

- Restatement of previously issued financial statements.
- Ineffective oversight by the company's audit committee.
- Ineffective regulatory compliance.
- Fraud of any magnitude on the part of senior management.
- Significant deficiencies, which remain uncorrected.

We cannot presume any of the foregoing situations constitute either a significant deficiency or material weakness without further consideration of the specific facts and circumstances. For example, many restatements result from evolving developments in financial reporting and, in some cases, changes to prevalent practice mandated by the SEC or other rule-makers. As indicated previously, we do not think auditor evaluation of audit committee effectiveness is appropriate given the inherent conflict of interests. Assessment of the significance of deficiencies in regulatory compliance and management fraud would require some consideration of the significance of the amounts involved and, with respect to management fraud, the position and authority of personnel. Finally, there may be very good reasons certain significant deficiencies are not corrected, particularly given the definitional issues discussed above regarding significant deficiencies.

We also think audit adjustments identified by the company's auditors may not necessarily be indicative of a material weakness or even a significant deficiency. Audit adjustments of relatively subjective estimates, for example, may more nearly represent a difference in judgment than a deficiency in the estimation process itself.

In addition, we do not think it reasonable to define deficiencies as "at least a significant deficiency" without regard to the significance of the amounts involved and all other pertinent facts and circumstances. More specifically, the categorical classification of the following deficiencies as "at least a significant deficiency" does not seem appropriate:

- Controls over the selection and application of accounting principles.
- Antifraud programs and controls.
- Controls over non-routine and non-systematic transactions.
- Controls over the period-end financial reporting process.

Furthermore, changes in control procedures and practices, such as antifraud programs, controls and procedures, are not necessarily indicative of deficiencies. Controls and procedures evolve over time and adapt to business innovation, technology and consequent changes in overall business practices. Moreover, changes in accounting practices are likewise not necessarily indicative of deficiencies as prevalent practices evolve over time with changes and improvements in prevalent financial reporting and accounting practices.

<u>Auditor Responsibility for Reporting all Deficiencies to Management</u>

The requirement for auditors to report ALL deficiencies to management is, without any possible doubt, much too broad. Presumably this would require reporting deficiencies in internal control over financial reporting - even where effective mitigating controls exist. Perhaps consideration should be given to hierarchy of scale, which is common in large, multinational companies, where certain deficiencies are discussed and resolved at the local level and are not escalated further.

Auditor Responsibility for Quarterly Disclosures

The scope of the auditor's responsibility for quarterly disclosures about internal control is ambiguous and there is no requirement under the Sarbanes-Oxley Act for the auditor to perform work relative to the company's quarterly disclosures. Furthermore, the differing levels of auditor responsibility regarding the management's quarterly disclosures versus management's annual assessment may create more investor confusion and further widen the "expectations gap".

Areas for Additional Guidance

We suggest the Board consider providing additional guidance in the following areas:

- Expand on guidance regarding appropriate framework for IT controls:
    - Incorporate reference to "Control Objectives for Information and Related Technology" (COBIT), published by the IT Governance Institute.
    - Reference recent Discussion Document published by the IT Governance Institute and ISACA regarding applicable IT control objectives and controls ("IT Control Objectives for Sarbanes-Oxley: The Importance of IT in the Design, Implementation and Sustainability of Internal Controls Over Disclosure and Financial Reporting").
- Identify independence and internal control-related services, which would compromise auditor independence.
- Clarify independence issues where service provider audits are performed by the company's external auditor.
- Identify time frame necessary to establish newly instituted controls are effective.

We thank you for the opportunity to express our views in this letter. If you have any questions or would like to further discuss our comments, please feel free to contact Dennis Dooley at (248) 372-3306 or me at (310) 615-1728.

Sincerely,

Leon J. Level
Chief Financial Officer

cc:

Mr. William J. McDonough, Chairman
Ms. Kayla J. Gillan, Board Member of the PCAOB
Mr. Daniel L. Goelzer, Board Member of the PCAOB
Mr. Bill Gradison. Board Member of the PCAOB
Mr. Charles D. Niemeier, Board Member of the PCAOB
Dr. Douglas R. Carmichael, PhD., CPA,CFA.

Exhibit 1

Response to the Questions Set Forth in PCAOB Release No. 2003-017, "Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements" (the "Proposed Standard")

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?

   Yes, we think it is appropriate to refer to the auditor's attestation of management's assessment as the audit of internal control 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?

   Yes, the audits of the financial statements and of internal control over financial reporting are complementary; performance of these audits by different auditors could potentially diminish the effectiveness of both audits.

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?

   No, nothing short of a full audit of the financial statements would provide equivalent coverage. Furthermore, separate audits of the financial statements and internal control over financial reporting would generally not be cost effective.

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?

   No comment.

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 the interviews of the company's senior management about possible fraud.

No, specification of the level of competence and training would be overly prescriptive.

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, requiring the auditor to both evaluate management's assessment and obtain, directly, evidence about the effectiveness of internal controls is appropriate. Evaluating management's assessment without directly evaluating internal control over financial reporting would not provide a substantive basis for the auditor's report and would not meet expectations of investors and other users of the reports.

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

   Yes, the Board's criteria regarding adequacy of management's documentation appears appropriate.

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 a significant deficiency or material weakness in internal control?

   Yes, the assessment as to the significance of the deficiency should be subject to auditor judgment based on all the relevant facts and circumstances. Inadequate documentation would not necessarily represent a significant deficiency or material weakness, in and of itself.

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

   Yes, walkthroughs are a widespread practice and the objectives are sufficient to warrant inclusion of this procedure as a part of the audit of internal control over financial reporting.

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 audit, or others?

    No, we do not think the walkthrough would necessarily need to be performed by the auditor. In principle the auditor should be allowed to use documented walkthroughs performed by management, internal audit, or others. The extent of the use of such walkthroughs and tests to be performed directly by the auditor would depend upon the facts and circumstances.

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?

    No, the auditor should be able to place reliance on work performed in prior years where such work is relevant to the current period. An example of this would be tests of application program controls. If such controls are tested in connection with the initial implementation of a new system it would only seem necessary to test changes in subsequent periods, assuming the auditor has tested IT general controls (including program change controls) and determined such controls are effective. This approach is referred to as "baselining" application controls and is a long established, widely accepted practice in use in audits of service providers under Statement on Auditing Standards No. 70 ("SAS 70 audits"), as well as audits of IT controls in conjunction with audits of financial statements.

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

    In principle, the auditor should be able to place reliance on the work of others, provided the auditor has:

    - **Evaluated the competence, objectivity and independence of the persons performing such work (as required under Statement on Auditing Standards No. 65), and**

    - **Reperformed such tests, or directly performed such independent tests, as are necessary to corroborate the results of such work.**

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

    Generally, we think the Proposed Standard requires an excessive scope of work for the audit of internal control over financial reporting in that it (1) mandates certain controls be evaluated directly by the auditor and (2) restricts the extent of reliance which the auditor may place on procedures performed by management, internal audit, or others. As a result, the Proposed Standard would result in substantial duplication of work as to audit work performed in prior years, as well as between audit work performed by the internal auditors and the external auditor.

More specifically, the Proposed Standard requires the auditor to directly perform all work, and not rely upon efforts of management, internal audit, or others, in the following areas:

- **Controls which are part of the control environment, such as controls designed to prevent and detect fraud;**
- **Controls over the period-end financial reporting process;**
- **Controls which have a pervasive effect on the financial statements, such as information technology general controls; and**
- **Walkthroughs for all of the company's significant processes.**

In principle, there is simply no reason the auditor should not be able to place reliance on the work of others in evaluating these controls, provided the auditor has:

- **Evaluated the competence, objectivity and independence of the persons performing such work (as required under Statement on Auditing Standards No. 65), and**
- **Reperformed such tests, or directly performed such independent tests, as are necessary to corroborate the results of such work.**

We think these restrictions will materially unnecessarily burden the entire economy with excess cost.

The extent of reperformance and independent tests should depend upon: the results of the tests performed by others; materiality, risk of misstatement, and degree of judgment or estimation associated with the related account balance or disclosure; degree of judgment required to evaluate the operating effectiveness of the control, subjectivity of the tests, and pervasiveness of the control. Such reliance is particularly appropriate where testing has been performed by internal audit in accordance with the Standards for Professional Practice of Internal Auditing issued by the Institute of Internal Auditors ("IIA"), and where the internal audit function is objective and independent from management. In fact, in most cases, the company's internal audit personnel would be at least as well qualified, and in many cases better able, to evaluate these control areas than the external auditors based on their knowledge of the company's industry, business, practices and procedures, processes and information technology systems.

Furthermore, the auditor should be able to fully rely on work of experienced internal audit personnel for controls over significant non-routine and non-systematic transactions, such as accounts involving significant judgments and

estimates, where such personnel are judged to be sufficiently competent and knowledgeable, as well as objective and independent from management.

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?

    No, the auditor should be able to place greater reliance on the work of internal audit, including all the three categories of controls identified in the Proposed Standard (refer to response to question 13 above).

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)?

    Yes, the extent of reperformance should be subject to auditor judgment based on all the relevant facts and circumstances.

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?

    No, the auditor should not be required to directly perform any minimum level testing, nor restricted in the reliance he may place on the work of others. The auditor has ultimate responsibility for his opinion, but he should be able to place reliance on the work of others, provided adequate evidentiary matter supports the work and he is satisfied as to the competence, objectivity and independence of personnel performing the work. He should be able to base his opinion on the quality and sufficiency of the evidentiary matter.

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?

    We think the definition of a significant deficiency is far too broad and all encompassing. Deficiencies with a potential misstatement of more than an inconsequential amount would encompass substantially all deficiencies. This would make it difficult to distinguish more significant deficiencies in internal control over financial reporting from matters of far less importance. We also think use of such a vague threshold as "inconsequential" would result in fairly significant diversity in practice since there is no existing usage of this term in either auditing standards or generally accepted accounting principles.

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?

    Except as noted below, the examples in Appendix D provide helpful guidance as to classification of significant deficiencies and material weaknesses.

    Intercompany procedures should not result in significant deficiencies or material weaknesses unless the intercompany balances do not eliminate without unreconciled differences in consolidation. If the intercompany balances eliminate in consolidation they have no effect on the financial statements and, as a consequence, deficiencies in internal control over itercompany balances could not result in significant deficiencies or material weakness.

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

    Yes, the severity of internal control deficiencies must be evaluated by the auditor based on all the relevant facts and circumstances.

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?

    No, the requirement for auditors to report ALL deficiencies to management seems much too broad. Presumably this would require reporting deficiencies in internal control over financial reporting - even where effective mitigating controls exist.

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

    No, we do not think the following circumstances warrant the presumption it "should be regarded as at least a significant deficiency and is a strong indicator a material weakness exists" without further evaluation of all the relevant facts and circumstances:

    - **Restatement of previously issued financial statements.**
    - **Ineffective oversight by the company's audit committee.**
    - **Ineffective regulatory compliance.**
    - **Fraud of any magnitude on the part of senior management.**

- **Significant deficiencies, which remain uncorrected.**

We cannot presume any of these situations constitute either a significant deficiency or material weakness without further consideration of the specific facts and circumstances. For example, many restatements result from evolving developments in financial reporting and, in some cases, changes to prevalent practice mandated by the SEC or other rule-makers. As indicated previously, we do not think auditor evaluation of audit committee effectiveness is appropriate given the inherent conflict of interests. Assessment of the significance of deficiencies in regulatory compliance and management fraud would require some consideration of the significance of the amounts involved and, with respect to management fraud, the position and authority of personnel. Finally, there may be very good reasons certain significant deficiencies are not corrected, particularly given the definitional issues discussed above regarding significant deficiencies.

We also think audit adjustments identified by the company's auditors may not necessarily be indicative of a material weakness or even a significant deficiency. Audit adjustments of relatively subjective estimates, for example, may more nearly represent a difference in judgment than a deficiency in the estimation process itself.

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?

    No, we think requiring the auditor to evaluate the effectiveness of the company's audit committee creates an inherent serious conflict of interests in view of the committee's responsibility for appointing the auditor. Furthermore, it may also serve to undermine an effective relationship between the company's board of directors, audit committee, management and external auditor. We think it is appropriate for the auditor to consider performance of the audit committee in evaluating the company's control environment. However, we do not think it would be practical to require an evaluation of audit committee effectiveness in view of the inherent conflict.

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

    No, we do not think the auditor could effectively evaluate the effectiveness of the company's audit committee due to the inherent conflict of interests.

24. If the auditor concludes that ineffective audit committee oversight is a material weakness, rather than require the auditor to issue an adverse opinion with regard to the effectiveness of the internal control over financial reporting, should the standard require the auditor to withdraw from the engagement?

No, if, in fact, this resulted in an actual material weakness we do not think the auditor should withdraw from the engagement.

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?

    Yes, we think consistency with the management reporting model is essential in this circumstance.

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

    No.

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?

    Yes, we agree that expressing an opinion on management's assessment could result in confusion. Reporting directly on the effectiveness of the company's internal control over financial reporting better communicates to the report users the effect of such conditions, because directly reporting more clearly states the auditor's conclusions.

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

    Yes, we suggest the Board identify independence and internal control-related services which would compromise auditor independence.

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

    Yes, we think the Board should specifically prohibit design and implementation and testing of internal controls over financial reporting, as well as direct assistance to the company in documenting and evaluating its controls. The Board should specifically indicate recommendations regarding internal controls arising from the auditor's audits of the financial statements and internal controls would not compromise their independence.

30. Are the auditor's differing levels of responsibility as they relate to management's quarterly certifications versus the annual (fourth quarter) certification, appropriate?

    No, we think the differing levels of auditor responsibility regarding the management's quarterly disclosures versus management's annual assessment may create more investor confusion and further widen the "expectations gap".

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

    No, the scope of the auditor's responsibility for quarterly disclosures about internal control is ambiguous and there is no requirement under the Sarbanes-Oxley Act for the auditor to perform work relative to the company's quarterly disclosures.

From: Lee Level [llevel@csc.com]
Sent: Monday, March 08, 2004 1:15 PM
To: Comments
Subject: PCAOB Rulemaking Docket Matter No. 008, Proposed Auditing StandardRegarding Internal Controls Over Financial Reporting

Importance: High

March 8, 2004

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W., 9TH Floor
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 008,
Proposed Auditing Standard Regarding Internal Controls Over Financial Reporting

FILED ELECTRONICALLY (comments@pcaobus.org)

Dear Board Members and Staff,

We strongly urge the Board to provide a comment period for the proposed auditing standard regarding internal controls over financial reporting.

Your February 24 news release announced an open meeting to be held March 9 "to consider adopting an auditing standard for internal control over financial reporting." The release also states, "The text of the final standard will be posted to the Web site as soon as possible after the Board's meeting." It appears you received nearly 200 comment letters on this proposal, with wide ranging input and only three months to draft broad revisions. As one of many responsible, conscientious members of your public company constituency, we highly recommend a comment period following the March 9 open meeting. Much discussion in your public community indicated hopes for a published draft in advance of the open meeting. As the draft has not yet been exposed as of today, March 8, we can only assume the Board is planning adequate time for comment before the final standard is posted.

Thank you for your consideration. Please feel free to contact me at (310) 615-1728.

Sincerely,

Leon J. Level
Chief Financial Officer,
Computer Sciences Corporation

CBI
THE VOICE OF BUSINESS

21 November 2003

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street NW
Washington DC 20006-2083
USA

Dear Sirs

PCAOB Rulemaking Docket Matter Number 008

Proposed Auditing Standard – An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

The Confederation of British Industry ("CBI") is the principal business association in the United Kingdom representing all sizes of both UK companies and foreign companies with places of business in the UK, and including UK companies who are listed or traded on the US securities markets.

We have been closely following the implications and requirements of Sarbanes – Oxley for UK companies affected, who are anxious to understand the implications of, and observe the requirements of, and understand the implications of, the US legislation and rules made by the SEC and other regulatory bodies which affect them.

Accordingly, the CBI welcomes the opportunity to comment on proposed rules and requirements which will affect UK companies with listings in the US.

Our comments are directed from the standpoint of seeking to ensure proportionate and appropriate rules, which will not result in excessive burdens or costs being placed on UK companies and their audit firms, whilst remaining consistent with the requirements of Sarbanes – Oxley.

Clive Edrupt – Company Affairs
DL: + 44 (0) 20 7395 8042 DF: +44 (0) 20 7836 1114 E: clive.edrupt@cbi.org.uk

Key issues for CBI member companies

1. Adverse audit opinions

We do not believe that a material weakness should automatically result in an adverse opinion. External auditors should use their professional judgement to determine whether a material weakness merits a qualified rather than an adverse opinion. The PCAOB could provide guidance on situations in which an adverse, rather than a qualified, opinion would be appropriate.

The SEC interpreted the requirements of section 404 to relate to internal controls over financial reporting. The proposed standard sometimes refers to 'internal control' and sometimes to 'internal control over financial reporting'. It is not always clear as to whether references to internal control in the text should be read as references to internal control over financial reporting. We suggest that the matter should be clarified at the beginning of the standard.

2. Reporting of control weaknesses

We suggest that the requirement for the external auditor to communicate *all* deficiencies to the audit committee will usually lead to excessive information for audit committees. This requirement should be amended to exclude all the deficiencies already reported by internal auditors, as well as enabling the grouping of similar types of deficiencies.

We do not accept the proposition that a significant deficiency that remains uncorrected after some reasonable period of time is a strong indicator of a material weakness. As an example, could this encompass a judgement that it is 'reasonable' not to correct a deficiency where the costs of the control exceed the benefits? A further issue is whether the aggregation principle applies in situations where a company has several deficiencies in unrelated areas. If it does, then adverse audit opinions may become common and their significance will be devalued.

3. Level of controls testing

The examples of control testing procedures illustrate that a very substantial amount of audit work is expected of external auditors at this basic level. The issuer is already required to carry out its own testing in this regard and those tests should yield the same results as external audit testing. We are not convinced that the requirement to test so much at this low level is necessary to protect investors.

Whilst we would expect basic low level controls to form an important element of the overall comfort obtained by CEOs and CFOs when making their certification, we would expect that they would represent a relatively low proportion. For example, high-level detective controls are typically a very significant element of overall comfort but they are not addressed in the examples.

4. Controls which do not naturally give rise to documentary evidence

Effectively designed controls are not always easy to demonstrate or document. For example, day to day supervision, coaching and reviewing of staff and their work in the accounting department are sound preventative controls but are ordinarily not documented on a continuing basis. Despite this, external auditors can often, by a process of enquiry and proper evidential corroboration, gain reasonable assurance that such controls exist and work effectively. The proposed standard indirectly plays down the importance of such controls and may encourage companies to prepare documentation that would not otherwise be necessary from a business point of view. We envisage that even routine meetings of management that act as a form of control, such as credit control meetings, will now have to be documented in detail to satisfy the perceived requirements of the standard. This will add additional cost and bureaucracy.

The operation of some IT controls may also not be easy to document to the level that may be perceived as necessary under the proposed standard. We question whether all this additional work on documentation will provide an increased level of protection for investors commensurate with the increased cost of compliance. We also question whether the proposals go further than the intentions of the Sarbanes-Oxley Act.

5. Weakness identification

The proposed standard requires the auditor to issue an adverse opinion regarding the effectiveness of internal control over financial reporting in case of one or more material weaknesses. This includes the identification by the external auditor of a material misstatement in the year-end financial statements that was not identified by the company’s internal controls, even if management subsequently corrects the misstatement prior to issuance of the financial statements.

This will have a profound effect on the relationship between an entity’s management and its external auditors, since it will increase resistance to adjustments proposed by external auditors. Even where the need for an adjustment is agreed, there will be unnecessary arguments as to which party identified the weakness incentive first. It may also make it difficult for external auditors to perform their work because management may try to keep them out until the preparation of the financial statements is at an advanced stage, thus ensuring that the auditor is not the first to identify adjustments.

We hope you find these comments helpful.

Yours faithfully

CLIVE EDRUPT
CBI Company Affairs

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Congress of the United States
House of Representatives

GREGORY W. MEEKS
6TH DISTRICT, NEW YORK

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ASIA AND THE PACIFIC

WHIP AT LARGE

February 6, 2004

William McDonough
Chairman
Public Company Accounting Oversight Board
1666 K Street, NW 9th Floor
Washington, DC 20006

Re: PCAOB rulemaking Docket Matter No. 008
Comments on Proposed Auditing Standard

Dear Chairman McDonough:

As Members of Congress we are writing to you in connection with the Proposed Auditing Standard-An Audit of Internal Control Over Financial Reporting Performed in Conjunction With An Audit of Financial of Financial Statements. This standard requires Audit firms to attest not only to the reliability of a company's financial statements but also to attest to management's assessment of the effectiveness of the company's internal controls over financial reporting. The auditor would be required to understand the systems in place, design and test the system, and provide an analysis on the efficacy of that system.

This would not only be a major initiative for each auditing firm but will also significantly raise the audit cost for the company being audited. Both the auditing firm and the audited company would need to increase staffing to meet this new standard. It is our understanding that even major firms such as Microsoft have voiced concerns about the increased cost that would result from the new standard.

At this point in time there are only four major accounting firms (the Big 4) to perform auditing services on the largest 1000 public companies. This new standard developed to meet the requirements of Sarbanes-Oxley Section 404 (b), will in essence bundle all of this work within the Big 4 firms. In our opinion, this not only contradicts the White House strategy for increasing opportunities for small business, but could violate the spirit of Sarbanes-Oxley by encouraging self dealing amongst firms.

Therefore, we recommend that the standard require the large public accounting firms to subcontract smaller firms to perform the internal control testing requirements. The use of smaller less expensive firms will decrease the cost to the audited companies and provide these smaller firms with greater opportunities and experience in working with larger more sophisticated firms; an experience they can bring to their smaller clientele. The larger firms could provide leadership through oversight of the work.

In their comment to the PCAOB, the independent risk consulting firm Protiviti states,

> "The auditor should be allowed to rely on competent and objective internal auditors (or other similar parties, such as a separate process or risk control group which does not have the responsibility for executing processes) in the performance of walkthroughs that are effectively documented, provided the auditor is able to satisfy himself or herself about the adequacy of this work through appropriate procedures."

In addition, Price Waterhouse Coopers LLP, one of the Big 4 accounting firms, states in their response, in the section Use of the Work of Others

> "We believe that it is appropriate to consider the work of others in certain circumstances. We agree that the auditor's use of others' work must be subject to the auditor's overall conclusion, using professional judgment, that his or her own work provides the "principal" evidence for the auditor's opinion."

We hope you will strongly consider this proposal and include it in the final rule.

Sincerely,

Gregory W. Meeks
GREGORY W. MEEKS,

Barbara Lee
BARBARA LEE

Julia Carson
JULIA CARSON

Wm. Lacy Clay
WM. LACY CLAY

MAJOR OWENS

WILLIAM J. JEFFERSON

JUANITA MILLENDER-MCDONALD

CAROLYN KILPATRICK

STEPHANIE TUBBS-JONES

From: Kortokrax, Philip F. [PFKORTOKRAX@coopertire.com]

Sent: Tuesday, November 25, 2003 9:05 AM

To: Comments

Cc: 'fholman@mapi.net'

Subject: Alliance/MAPI Statement to PCAOB re SOX 404 Proposed Attestation Standard

Dear Mr. Chairman and Members and Staff of the Board:
This is a brief note to express my concurrence with the statement from MAPI by Francis W. Holman, Jr. regarding the proposed standards for SOX 404. Please provide every consideration to these comments as you move towards issuance of your final rulings.

Best Regards,

Phil Kortokrax
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November 24, 2003

Office of the Secretary
PCAOB
1666 K Street NW
Washington, DC 20006-2803

Re: PCAOB Release 2003-017
Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements

Dear Secretary:

The Council of Institutional Investors, an association of more than 140 corporate, public and union pension funds collectively holding more than $3 trillion in pension assets, is writing in support of the PCAOB's proposed auditing standard, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements."

Audited financial statements are one of the primary sources of information available to guide and monitor Council members' investment decisions. The integrity of these statements is critical to Council members and their millions of pension system participants and beneficiaries. Since effective internal controls are a cornerstone of reliable financial information, Council members are interested in ensuring that internal controls are as effective as possible.

The Council agrees that outside auditors should be responsible for more than simply evaluating the adequacy of management's process for determining whether internal controls are effective. The investing public expects the outside auditor to not simply audit the financial numbers but also to test the effectiveness of a company's internal controls.

The Council wholeheartedly supports the PCAOB's provisions requiring outside auditors to evaluate management's process for determining the effectiveness of internal controls and to test whether the controls are effective and management's determination is appropriate.

Massive accounting scandals in recent years—at large and small companies—have shined a spotlight on outside auditors, audit committees and their critical role in assuring high-quality financial reporting. The Council has supported legislative and regulatory efforts to enhance the independence of audit committees and to ensure greater audit committee and outside auditor accountability to shareholders.

As a result, the Council strongly supports the proposal requiring the outside auditor to evaluate the effectiveness of the audit committee's oversight of the external financial reporting process and internal control over financial reporting, including whether audit committee members act independently from management.

The Council commends the PCAOB for the thoughtful and comprehensive approach taken in this proposed rulemaking. Please contact me with any questions.

Sincerely,

Sarah A.B. Teslik
Executive Director

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November 21, 2003

Via e-mail

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

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:

Covington & Burling is pleased to respond to the request of the Public Company Accounting Oversight Board for comments on its Proposed Auditing Standard referred to above (as so proposed, the "Standard"). Our comments relate solely to the application of the Standard to consolidated or majority-owned subsidiaries ("Subsidiary Registrants") that have non-equity securities listed on a national securities exchange or quoted in an automated inter-dealer quotation system of a national securities association ("SROs"). We believe that the Standard does not make adequate provision for the Subsidiary Registrant exemption provided by the SEC in its recently adopted Rule 10A-3(c)(2) under the Securities Exchange Act of 1934. In addition, we wish to call to the attention of the PCAOB certain other issues unique to Subsidiary Registrants that are raised by the Standard.

As you know, Securities Exchange Act Rule 10A-3, which was adopted pursuant to Section 301 of the Sarbanes-Oxley Act of 2002, directs SROs to prohibit the listing of any security of an issuer that is not in compliance with prescribed audit committee standards. In response to comments received from Subsidiary Registrants and their parent companies on Rule 10A-3 as initially proposed, the SEC adopted an exemption to Rule 10A-3 as adopted for Subsidiary Registrants (the "Subsidiary Registrant Exemption") if the parent company (a) has a class of common equity securities (or similar securities) listed on an SRO and (b) is subject to, and otherwise in compliance with, Rule 10A-3.[1]

Evaluating the Effectiveness of the Audit Committee's Oversight of the Issuer's External Financial Reporting and Internal Control Over Financial Reporting

Evaluating Audit Committee Independence

Paragraphs 56-59 of the Standard prescribe standards for an auditor's evaluation of the effectiveness of an audit committee's oversight of an issuer's external financial reporting and internal control over financial reporting. The Standard directs auditors to place particular emphasis in the course of their evaluation on the independence of audit committee members from management and an issuer's compliance with applicable listing standards adopted pursuant to Section 301 of the Sarbanes-Oxley Act. These listing standards include Rule 10A-3.

In the SEC Audit Committee Release, the SEC explains that subjecting Subsidiary Registrants to the audit committee independence and other requirements of Rule 10A-3

> would add little additional benefit if the subsidiary is closely controlled or consolidated by a parent issuer that is subject to the requirements. Instead, imposing the requirements on these subsidiaries could create an onerous burden on the parent to recruit and maintain an audit committee meeting the requirements for each specific subsidiary.

Therefore, the SEC determined it was appropriate to exempt Subsidiary Registrants from the requirements of Rule 10A-3.[2] However, the Standard does not provide a corresponding exemption for Subsidiary Registrants.

We note that Rule 10A-3(d) requires an issuer utilizing certain exemptions from Rule 10A-3 to disclose in its annual report and proxy statement the nature of the exemption and its assessment of whether, and if so how, such reliance would materially adversely affect the ability of the issuer's audit committee to act independently and to satisfy the other requirements of Rule 10A-3. The purpose of Rule 10A-3(d) is to alert an issuer's securityholders that an issuer's audit committee may not be acting independently or have systems in place to insure effective oversight of the company's external financial reporting and internal control over financial reporting. Significantly, Rule 10A-3(d) does not require an issuer availing itself of the Subsidiary Registrant Exemption to make such disclosure or assessment. This, we believe, evidences further recognition by the SEC that reliance on the Subsidiary Registrant Exemption does not jeopardize the effectiveness of the Subsidiary Registrant's external financial reporting and internal control over financial reporting.

For the reasons stated above, we believe that evaluation under the Standard of the effectiveness of an audit committee's oversight of the company's external financial reporting and

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[1] The SEC determined that this exemption was consistent with the purposes and policies of Section 301 of the Sarbanes-Oxley Act and the protection of investors. See Section II(F)(2) of SEC Release No. 33-8220, dated April 9, 2003 (the "SEC Audit Committee Release").

[2] Section II(F)(2)(a) of the SEC Audit Committee Release.

internal control over financial reporting and, in particular, the independence of audit committee members from management, should explicitly recognize that Subsidiary Registrants may be exempt from the application of Rule 10A-3 (including the audit committee independence requirements). The Standard should specifically affirm that the use by a Subsidiary Registrant of such exemption should have no negative effect on the auditor's evaluation of the effectiveness of an audit committee's oversight. By enacting the Subsidiary Registrant Exemption, the SEC has endorsed the view that investor protection is not compromised by exempting Subsidiary Registrants from the audit committee independence requirements (and the other requirements) of Rule 10A-3 where the parent company audit committee is providing that protection, and we strongly urge the PCAOB to endorse that view.

Evaluating the Effectiveness of an Issuer's Audit Committee in Other Contexts

Paragraph 56 of the Standard notes the important role that an issuer's audit committee plays within the company's control environment by setting a positive tone at the top and in monitoring components of internal control over financial reporting by challenging, and creating an environment where others within the Company are able to challenge, the company's financial activities. In order to eliminate any confusion over references to the term "audit committee" as used in paragraph 56 and throughout the Standard, footnote 12 of the Standard provides that if an issuer lacks an audit committee, all references to the audit committee in the Standard shall apply to the entire board of directors of that issuer. As such, footnote 12 reflects the definition of "audit committee" found in Section 3(a)(58) of the Securities Exchange Act of 1934. However, while footnote 12 removes this ambiguity in the audit committee/full board context, it does not address the similar situation that may exist in the Subsidiary Registrant context.

The Standard contains numerous references to the obligation of an auditor to make assessments of an issuer's audit committee's performance on matters other than independence.[3] In the Subsidiary Registrant context, each of these enumerated audit committee activities could be undertaken by any of: (i) the audit committee of a Subsidiary Registrant; (ii) the full board of a Subsidiary Registrant; or (iii) the audit committee of a Subsidiary Registrant's parent. We believe that a Subsidiary Registrant should be able to retain flexibility to allocate these responsibilities as it (or its parent) sees fit (so long as the parent company discharges its obligations to supervise the Subsidiary Registrant's audit committee under Rule 10A-3). For example, there may be circumstances where a Subsidiary Registrant's audit committee monitors its code of ethics while the audit committee of the Subsidiary Registrant's parent oversees the Subsidiary Registrant's external financial reporting process and internal control over financial reporting. We believe that the Standard should be clarified in order to avoid confusion as to what committee or equivalent body is performing the role of "audit committee" for purposes of the Standard and, at the same time, to maintain maximum flexibility for parent companies to manage their Subsidiary Registrants. The Standard should explicitly instruct Subsidiary Registrants and/or their parent companies to include in their management report a specific identification of the committee or equivalent body responsible for each required audit committee

[3] See, e.g., paragraphs 24-25, 39 (bullet seven), 53 (bullet five), 72 (bullet six) and 126 (bullets three and seven) of the Standard.

activity and instruct auditors to assess the committee or equivalent body so identified as being responsible for the particular audit committee activity.

Mandated Communications with an Issuer's Audit Committee

The Standard contains numerous provisions that either require an auditor to make certain communications to the issuer's audit committee or make reference to such communications. These required communications include the following situations in which shortcomings have been identified by an auditor: (a) an auditor's determination that management has failed to meet certain obligations under the Standard (paragraphs 20 and 128(f)); (b) an auditor's identification during the course of an audit of significant deficiencies or material weaknesses in controls (paragraph 100) or in internal controls over financial reporting (paragraphs 190-91); (c) the failure of management to disclose or identify a material weakness in its management report (paragraph 163, second bullet); (d) the presence of a material misstatement of fact in a management report (paragraph 176); (e) the failure of management to respond to an auditor's communication that changes to the issuer's disclosure about changes in internal control over financial reporting are necessary (paragraphs 188-89); and (f) an auditor's identification during the course of an audit of fraud or possible illegal acts (paragraph 192).

In order to avoid any ambiguity in the Standard as to which committee or equivalent body of a Subsidiary Registrant should receive mandated communications from its auditors, we believe that the Standard should clearly state that such required communications should be made to the same committee or equivalent body that pre-approves the retention of the auditor by or on behalf of the Subsidiary Registrant pursuant to Rule 2-01(c)(7) of Regulation S-X.

Section II.H of the SEC Audit Committee Release clarifies that a parent company's audit committee is permitted under Rule 2-01(c)(7) to perform the pre-approval function for any consolidated subsidiaries both with respect to the parent company's consolidated financial statements and with respect to the financial statements of any consolidated subsidiary that also is an issuer.[4] The SEC Audit Committee Release further notes that there may be instances where a controlled consolidated subsidiary issuer has its own audit committee. In this case, only the subsidiary audit committee need pre-approve the auditor's audit services under Rule 2-01(c)(7). Finally, the SEC Audit Committee Release reminded issuers that in circumstances where the SEC's rules require auditors to communicate directly to the issuer's audit committee, the same body responsible for the pre-approval of audit and non-audit services pursuant to Rule 2-01(c)(7) should be the body to whom these required communications are made by the issuer's auditor.

We believe that there should be an explicit statement in the Standard that an auditor must deliver required communications pursuant to the Standard to the same committee or equivalent body that pre-approves the retention of the auditor by or on behalf of the Subsidiary Registrant.

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[4] Note that "controlled consolidated subsidiary issuers" is a subset of our defined term "Subsidiary Registrant," in that the latter term captures both consolidated subsidiaries and majority-owned subsidiaries. The Rule 10A-3(c)(2) exemption discussed in the first section of this letter applies to "a direct or indirect consolidated subsidiary or an at least 50% beneficially owned subsidiary of the issuer." The SEC discussion of the application of Rule 2-01(c)(7) in Section II.H of the SEC Audit Committee Release applies only to controlled consolidated subsidiary issuers and not to unconsolidated majority-owned subsidiary issuers. We do not believe that this distinction affects the analysis that follows.

This would have the benefit of removing any ambiguity in the Standard over what committee or equivalent body should receive communications required to be delivered to the "audit committee" pursuant to the Standard and harmonizing the Standard with the SEC's application of Rule 2-01(c)(7). We believe this can be most efficiently accomplished by adding a general statement to this effect to the Standard, rather than explicitly modifying each such reference.

* * *

We appreciate the opportunity to comment on the Standard. If you have any questions with respect to this letter or require any further information, please do not hesitate to contact the undersigned (212.841.1060: bbennett@cov.com) or David B.H. Martin (202.662.5128; dmartin@cov.com).

Bruce C. Bennett

cc: Jeffrey J. Minton
Special Counsel, Office of Rulemaking
Division of Corporation Finance
Securities and Exchange Commission

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Public Company Accounting Oversight Board
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November 21, 2003

via e-mail: comments@pcaob.org

Re.: PCAOB Rulemaking Docket Matter No. 008 – Comments to the Proposed Auditing Standard, "An Audit of Internal Controls Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements"

To the Members of the PCAOB:

The Credit Suisse Group appreciates the opportunity to respond to the request of the Public Company Accounting Oversight Board (PCAOB) for comments on the Proposed Auditing Standard, "An Audit of Internal Controls Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements" ("Proposed Standard").

As a foreign private issuer listed on the NYSE, the Credit Suisse Group (CSG) is pleased to see the attention being given by the SEC and PCAOB to the protection of investors in publicly held companies to restore confidence in the financial markets. CSG believes the spirit of the Sarbanes-Oxley Act, section 404 ("SOX 404") will significantly contribute to restoring confidence in the investment community.

CSG believes the objectives of SOX 404 and the restoration and maintenance of confidence in the financial markets should be achieved in an efficient and cost-effective manner, which is also in the best interests of investors. CSG has identified three general areas in the Proposed Standard that it finds to be of concern in relation to the role of the external auditor in reviewing an organization's internal controls over financial reporting, including the related management assessment of these controls, the proposed definitions of significant deficiency and material weakness, and testing type, size and timing.

A. Auditing Management's Assessment vs. Direct Evidence by the External Auditor

This comment addresses elements of the following questions from the PCAOB:

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?

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

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?

15. Is the flexibility in determining the extent of re-performance or the work of others appropriate, or should the auditor be specifically required to re-perform a certain level of work?

CSG's understanding of the initial basis of review for SOX 404 was that the external auditor would review management's assessment of internal controls over financial reporting. The Proposed Standard extends such review to encompass significant additional work by the external auditor to acquire "direct evidence" of the effectiveness of internal controls over financial reporting. In the spirit of SOX 404, CSG believes the Proposed Standard should focus primarily on ensuring that management is effectively assessing the company's internal controls over financial reporting.

CSG is concerned that such additional work by the external auditor to obtain direct evidence of the design and operating effectiveness of internal controls over financial reporting in addition to reviewing management's assessment:

- will lead to potentially a triple review of certain internal controls, as external audit, internal audit and management may review the same areas;
- will result in documentation and related testing work performed by management being re-created or re-performed by external audit to obtain direct evidence or to perform walk-throughs; and
- does not take sufficient account of the role of an existing, independent and effective internal audit function to provide external audit with additional support for its conclusions.

CSG recognizes that the external auditor must consider the materiality of specific financial statement line items, associated risk and the likelihood and impact of potential misstatements in performing its SOX 404 review work. CSG believes, however, that through the use of sound, professional judgment by the external auditor, the documentation and testing work that the external auditor should be permitted to rely on – including that of management's assessment – should extend further than suggested in the Proposed Standard.

Finally, CSG is concerned that if the external auditor is not permitted greater flexibility in relying on the process by which management performs this assessment and the quality of the results obtained, the additional costs associated with external audit fees and the duplicated efforts of company personnel to support the external auditor's direct evidence collection are not an effective use of the company's financial and other resources in light of the benefit to investors.

B. Material and Significant Weaknesses – Degree of Weaknesses Requiring an Adverse Opinion

This comment addresses elements of the following questions from the PCAOB:

> *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?*
>
> *25. Is it appropriate that the existence of a material weakness would require the auditor to express an adverse conclusion about the effectiveness of the company's internal control over financial reporting, consistent with the required reporting model for management?*
>
> *26. Are there circumstances where a qualified "except for" conclusion would be appropriate?*

CSG believes the definitions of "significant deficiency" and "material weakness" should be conformed to existing definitions in U.S. generally accepted auditing standards AU Section 325, *Communication of Internal Control Related Matters Noted in an Audit*, and AT Section 501, *Reporting on an Entity's Internal Control Over Financial Reporting*. CSG believes the Proposed Standard departs significantly from these existing accounting standards to make the threshold so low for determining significant deficiencies that there is almost no distinction between a deficiency in internal control over financial reporting and a significant deficiency. CSG is concerned that under the Proposed Standard most well-controlled companies would have significant deficiencies, and that would do nothing to improve the quality of financial reporting or investor understanding or confidence in financial reporting. Significant deficiencies in internal controls over financial reporting could become routine events, with little meaning for investors, causing companies and their management and internal and external auditors to use resources to report and correct deficiencies that are not commensurate with the effect they may have on the quality of financial reporting.

The Proposed Standard states that if one material weakness exists, or if several significant deficiencies exist that may aggregate to a material weakness, the auditor must issue an adverse opinion.

In the event a material weakness should exist, CSG believes that the external auditor should use its professional judgment to evaluate the type of weakness, mitigating controls, efforts to remedy the situation, as well as other relevant factors in assessing the impact on the audit opinion. The determination of the external auditor to issue a qualified or adverse opinion on the internal controls over financial reporting should be based on such evaluation and not solely on the quantitative existence of a material weakness, although cases will arise in which the quantitative effect of a material weakness results in a misstatement to the financial statements so material that the external auditor must issue an adverse audit opinion. The external auditor should have the flexibility to evaluate the efforts by an organization to correct, improve or mitigate areas of weakness, especially in the absence of material misstatements to the financial statements. Such efforts are a sign of effective internal controls to address new risks and weaknesses and resolve such issues promptly.

C. Testing Type, Size and Timing

This comment addresses elements of the following question from the PCAOB, in addition to addressing generally other elements of the overall section in the Proposed Standard on testing of 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?*

As performed during the course of normal audit work, auditors will regularly review the control risks, materiality of related financial statement line items and potential for misstatement, and historic experiences with various areas of a company's internal controls. CSG believes that the external auditor should be allowed to use its professional judgment based on, but not limited to, the above considerations, to determine which accounts and disclosures should be tested and whether or not these need to be tested on an annual basis. CSG recognizes that there will certainly be areas that the external auditor will, however, continue to test on an annual basis based on its judgment and risk assessment. CSG believes this same approach is relevant when reviewing management's assessment of the internal controls over financial reporting.

Related to the general topic of testing of operating effectiveness, CSG has the following comments:

The Proposed Standard includes examples of testing type, size and timing. These are discussed as being examples on which the external auditor could base the scope of its work. CSG believes that these should, however, be the basis for evaluating the quality of management's assessment and not the type, size and timing of testing necessarily expected of management in its assessment work.

CSG believes that testing type, size and timing should be a determination of management and be an integral part of assessing the adequacy of management's assessment process. Management will need to consider a number of factors in determining types and timing of tests and test size, including the nature of controls, frequency in which the controls are performed, potential impact and likelihood of risk addressed by the control.

The external auditor will subsequently have to judge whether management's assessment, including the testing type, size and timing, is effective and whether its basis for testing performance is appropriate.

We look forward to the completion of the final version of the Proposed Standard to enable an effective and efficient implementation of the requirements of SOX 404.

Should you have specific questions regarding our comments, we are pleased to discuss the practical concerns we have with members of the PCAOB.

Sincerely yours,

Philip Ryan
Chief Financial Officer
Credit Suisse Group

Rudolf Bless
Chief Accounting Officer
Credit Suisse Group

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November 21, 2003

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
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Subject: PCAOB Rulemaking Docket Matter No. 008

We are pleased to comment on the proposed Auditing Standard, "An Audit of Internal Control Over Financial Statement Reporting Performed in Conjunction with an Audit of Financial Statements." We understand the need to quickly prepare guidance for the numerous audits of internal control required by the Sarbanes-Oxley Act of 2002. Following are changes we suggest to improve the guidance in the proposed Standard and the resulting reports that will be issued.

1. The report on internal control over financial reporting that is included in the proposed Standard should be significantly revised. The proposed report is based on criteria that will be obscure to most users, and the report is not sufficiently descriptive or informative for most users.

First, the criteria referred to in the proposed report are not widely-known. Users now have a general understanding of "generally accepted accounting principles" and thus can absorb what that reference means when they read it in an auditors' report. Their understanding is assisted by the footnote disclosures of the accounting principles used. In the proposed report on internal control over financial reporting, however, the "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission" does not provide this understanding to users. Quickly, what are these criteria? How does "Internal Control—Integrated Framework" relate to "internal control over financial reporting"? Who are the Sponsoring Organizations and what is their authority to specify something? Who or what is the Treadway Commission? Why should this Framework be used as a basis for reporting? What does this Framework say? Is the Treadway Commission still active and updating its work as needed? How can someone get a copy of what the Treadway Commission issued? Why does the auditor's report on financial statements refer to PCAOB standards while the report on internal control over financial reporting refers to Treadway Commission standards?

In short, users will not adequately understand the basis used to evaluate internal control over financial reporting, and thus are likely to not understand, or to misunderstand, the report. More discussion in the management report and the auditor report of the criteria used is needed.

Second, the sample report gives a conclusion that the company's assessment about internal control over financial reporting is fairly stated, in accordance with some criteria (see prior paragraphs.) This report, however, gives the user no further information about the controls. There is no discussion of what the internal controls are over financial reporting, whether they are centralized or decentralized, whether there is an internal audit department, whether there is an audit committee, and so on. To illustrate our concern with the sparse information provided in this report about internal controls, imagine if the presentation of financial position and results of operations, and the auditor's report thereon, were to be similar to this proposal. There wouldn't be any financial statements or disclosures or other details. Instead there would be a statement by management that "we had a good year on revenue and income and have a strong balance sheet" with the auditor saying "we agree with their evaluation." Or perhaps, this report might say we had a "tough year" or that the balance sheet is "weak". This would be a very limited and poor degree of communication with users about financial position and results of operations. What is the user to make out of a brief report such as this? However, this is the level of information that will be provided by the proposed reports on internal control. Nothing about internal control over financial reporting is described or communicated, nothing is disclosed, nothing is discussed. The user is just given a conclusion that internal control over financial reporting is effective, but is not given a description of the internal control system over financial reporting, of what these internal controls are, of how they operate, of what they encompass. Further, the user has to guess what the criteria are that this report is based on--yes, the source of the criteria is mentioned, but what ARE the criteria? Nor does the auditor's report give a description of what was tested or of the various components of controls or the details of the criteria used.

Also, the presence of a fraud at a company may mean that the detection function of internal controls worked as intended and the fraud was brought to light—but the users may be confused and wonder how there could be a fraud when internal controls were reported as being effective and thus the fraud wasn't prevented from occurring in the first case. A better discussion of both the preventive and the detective nature of internal control over financial reporting in the proposed report might alleviate this possible confusion.

We suggest that both management's report and the auditor's report include significant additional information about both management's assessment of internal controls over financial reporting and the auditor's separate evaluation thereof. One section of these expanded reports should discuss design of internal controls over financial reporting and provide information about the areas where design was assessed, and how it was assessed. Another section of these expanded reports should discuss operating effectiveness of internal controls over financial reporting and how the operating effectiveness was assessed and tested. These additional sections should provide details for the user in the several areas that are evaluated: operating environment, tone at the top, risk management, control procedures, internal audit, monitoring, audit committee, revenue recognition, asset safeguarding, approval of expenditures, and so on.

Otherwise, the user will have limited knowledge of what was done by the auditor or of what assurance they should take from the auditor's report. These revisions are needed to improve communication with users and to avoid creating an "expectation gap" with users, who might come to expect that the report on internal control covers everything and that there is no cost-benefit consideration used in designing controls or in testing them.

2. The proposed report on internal control over financial reporting is an "on-off" switch. If there is <u>one</u> material weakness, the internal control system IN TOTAL is described as not

providing "effective internal control over financial reporting." It's as if there is NO internal control system at all, not one that happens to have one problem somewhere. See the sample report on page A-69 in the proposal, which indicates that because there is a material weakness, the achievement of the objectives of internal control over financial reporting has not occurred. However, paragraphs 8 through 11 of this proposed Standard appear to indicate that the objective of internal control over financial reporting is to prevent and detect misstatements.

The expanded report on internal control over financial reporting we suggest above should be able to provide a better balance, by not sounding that because there is ONE material weakness, the whole system is worthless. The more detailed report we discussed above will better enable preparers and auditors to convey the gradations of various control situations that will exist in entities due to size of company, risk, costs, and other factors, as well as to allow discussion of the presence of a weakness or two, and even cost-benefit decisions made regarding controls.

3. Continuing the topic just discussed in #2, if a material weakness exists, there still may be no misstatement that occurred. It is possible, among other reasons, that a suitable "tone at the top" provides such a sufficient preventive control that a weakness elsewhere was mitigated and a misstatement was prevented. The ultimate objective, for users, is the presence of proper financial reporting. Thus, the criteria used for deciding when a material weakness occurred might need to consider whether the material weakness "meant" anything or led to any problems in financial reporting.

4. This proposal is lengthy and complex. We believe working groups should be formed to help the Board's staff provide continuing and timely implementation guidance on questions that will undoubtedly arise in practice. These questions are likely to arise from preparers, who will be asked to prepare the needed documentation of internal controls and assessments under the rules prescribed in this proposal, and from auditors, who will face numerous issues as to extent of testing, extent of documentation, reporting, independence, and so on.

5. Throughout the sample reports, we suggest that every mention of "internal control" be revised to refer instead to "internal control over financial reporting." The scope of the auditor's evaluation and assessment is limited to the latter term, not to the broader concept of "internal control," and we suggest avoiding a possible area of confusion of users who might believe they are reading a report on all aspects of internal control.

6. In smaller entities, controls may be more informal than in larger entities. The proposed Standard in Appendix E takes notes of this. We suggest that, as part of the expanded reporting on internal control we earlier suggest, that the reports discuss some of the more informal ways in which internal control over financial reporting is maintained. A user should not see the same form of report for a small entity as for a larger entity and believe that their internal control systems thus have identical complexity and features.

7. Entities may have recently acquired another company just before year-end and be in the process of absorbing the acquisition, including making changes to conform the acquired entity's controls with the acquirer. An entity with a recent acquisition may find itself unable to determine whether internal controls are sufficient in the acquired entity, or unable to support its assessment with suitable documentation, or unable to apply its control structure to the acquisition, simply because there has not been enough time to do so. We suggest that special consideration be given in the report on internal control (already, as we suggested earlier, expanded in scope and content) so that the evaluation of the reporting entity can acknowledge

that a recently-acquired entity has controls that have not yet been evaluated by management. Users would be expected to understand and accept this situation because it is a logical feature of any significant acquisition and the resulting integration.

8. The various requirements for communications of material weaknesses by the auditor should discuss that these communications do not form the basis for management's conclusion about the absence of material weaknesses. It should be made clear, in every instance where the communication requirements are prescribed, that management cannot rely on the fact the auditor hasn't communicated a material weakness in forming management's conclusions about material weaknesses. It should be clear that the auditor's communications about material weaknesses can't be used as a basis for management's assessment.

9. The guidance for making significance decisions for testing (paragraph 60) refers to significant accounts "at both the financial statement level and then at the account or disclosure component level." We agree with "the financial statement level" and disagree with the "account" level. Going beyond the line items in the financial statements may mean, in smaller entities, going to hundreds or thousands of general ledger accounts, while larger entities could have hundreds of thousands of "accounts". Our concern about this point is heightened by paragraph 63, which states: "In some cases, separate components of an account may also need to be considered a significant account...". Does this mean that an entity with thousands of general ledger accounts might have yet even many, many more items to consider, considerably in excess of the number of accounts, as to components of these general ledger accounts? We suggest the guidance in this proposal remain consistently at the financial statement level. In fact, even at the financial statement line item level, some smaller balance items still may be too small a level at which to make significance decisions.

10. We suggest that the various discussions of what must be done in an audit of the financial statements be removed from this guidance on auditing internal control over financial statements. A specific example is the discussion in paragraph 141 that the substantive procedures must include "examining material adjustments made during the course of preparing the financial statements." "Material adjustments made during the course of preparing the financial statements" could include reclassifications to comply with GAAP, closing net income to retained earnings, and a host of other normal entries made to record December's sales, calculate income taxes, and so on. Whatever the merits of requiring testing of material adjustments in the financial statements, we suggest all such guidance be handled instead in auditing standards that focus specifically on auditing financial statements, and not in a statement with the different objective of auditing internal control over financial reporting. In that way, all the standard-setting on auditing financial statements can be evaluated on its merits instead of being decided now as an "aside" in this proposal on internal control.

11. There may be significant independence implications in the variety of tasks that an auditor, especially an auditor of a smaller entity, could be called upon to assist management with. Tasks could range from education for the audit committee to performing tests that management could rely on. Some of this assistance would be allowed, some would not. We suggest the Board give consideration now to the areas in which an auditor could assist management with in internal control analysis, especially on a smaller entity, and provide guidance now, as the initial phases of implementing this new standard will be crucial. The guidance is needed in the areas between the clear calls as to what is allowable versus what is not. To avoid unneeded problems with independence, and to allow providing smaller entities with much-needed assistance, we suggest the Board provide more robust guidance on the independence rules to allow audit

committees and auditors to make proper decisions about the scope of assistance that may be obtained.

12. This proposed Standard will lead to a significant increase in the amount of work needed from an auditor, at the same time that there will be a shortening by one-third of the time available to complete the year-end audit and perform the needed procedures for filing of Form 10-K, for accelerated filers. Accordingly, we suggest the Board revisit the scope of the procedures in this proposal that are stated as those that must be performed after year-end, to ensure that there remains enough time to perform the procedures actually needed within the deadlines provided.

13. Paragraph 101 prescribes that the work performed on each audit of internal control "each year" should provide "sufficient evidence about whether the company's internal control over financial reporting, including the controls for ALL internal control components, is operating effectively." (emphasis added). We suggest this be revised to allow the use of prior information obtained.

An analogy to an audit of financial statements may provide a useful illustration. In 2002, an entity may have added a fixed asset, which the auditor audited. For the audit for 2004, would the auditor need to obtain evidence about the fixed asset addition from 2002, which remains on the financial statements of the entity at year-end 2004, or would the Board allow the auditor to rely on the evidence obtained in the 2002 audit. If the Board will allow reliance on prior evidence for financial statement presentation, which we think makes all the sense in the world, why must instead, for the audit of internal control over financial reporting, involving the numerous systems and accounts and assertions that make up the matter to be audited, why should the auditor be required to ignore all the testing done by the auditor in prior years? We suggest this proposed Standard take a revised position on this cost-benefit issue to allow the use of prior, valid evidence.

14. Appendix E may provide smaller companies with an ability to provide less documentation of their internal control system. We suggest that Appendix E balance its discussions of the matters discussed in, for example, paragraph E3 ("written policies…. often less complete or less formal"), and similar wording elsewhere, with guidance that written documentation is required of management nevertheless.

15. We note the requirement to assess the effectiveness of the audit committee, as part of the auditor's reporting on internal control over financial reporting. At first look, this appears problematic, as the audit committee is the one that hires the auditor, is the one that approves the scope of the auditor's work, and is the one to whom the auditor reports various matters. Thus, it might seem that the auditor is reporting on the effectiveness of those that hired the auditor. However, the audit committee is indisputably part of the internal control system, and the Sarbanes-Oxley Act of 2002 does require a report by management and by the auditor on internal control over financial reporting, so we concur that the scope of the auditor's work must include assessments of the role and effectiveness of the audit committee. We do suggest the Board take especial note of the sensitivity of this relationship and provide extensive guidance on how the auditor is to assess, and report on, their assessment of the role of the audit committee, those that hire the auditor.

If you have any questions or would like further discussion, please contact Jim Brown.

Very truly yours,

Crowe Chizek and Company LLC

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

Dear Mr. Secretary:

The audit of internal controls as proposed exceeds the needs of management and shareholders. The cost investment for compliance is significant with little impact on reporting of financial position or results. Shareholders are primarily interested in the financial statements and not the internal workings to report the financials. The traditional external audit focus on substantiating the financials is more attuned to meeting investor requirements than an audit of internal controls. Providing sufficient documentation to meet the proposed standard imposes a substantial burden on companies with a questionable return. The audit focus should be on management processes to evaluate and maintain controls versus a review of the internal control structure.

The following comments are offered regarding the provisions of the proposed standard.

Question 6

Section 404(b) of the Sarbanes Oxley Act of 2002 requires that the registered public accounting firm attest to and report on the assessment made by the management. The requirements outlined in the proposal seem to go well beyond the requirement of the law. An audit of internal controls as proposed effectively duplicates management's responsibilities. The focus of the public accounting firm's work should be an evaluation of the process management uses to assess the quality of management's internal control system. To evaluate management's process would require some sample testing of the evaluation process and therefore some of the specific controls but would clearly not involve an in depth review of the internal controls as suggested in Paragraph 27 requiring evidence regarding all assertions for all significant accounts and disclosures. The proposed standard suggests that the accountant must fully develop their own opinion on the controls to be able to attest to management's work. The intent should be to validate the adequacy of management's process and not to re-perform the assessment.

Question 8

An inadequate level of documentation should be considered an internal control deficiency but should not automatically rise to the level of a significant deficiency or a material weakness. Levels of documentation can vary widely and should be subject to debate between management and the accountant prior to assigning a level of significance.

Question 10

In the initial review, having the auditor involved in walkthroughs should facilitate understanding of the processes. In future years however, the auditor should rely on the walkthroughs performed by management or their internal auditors and only be directly involved on a sample basis to assess the effectiveness of the Company performed walkthroughs.

Questions 12, 14, 16

The ability to rely on the work of management is too restrictive. A distinction should be made between requirements of an initial review and subsequent years. In the initial year expecting the auditors own work to provide the principal evidence for the audit opinion makes sense. In subsequent years, more reliance could be placed on the work performed by management especially if performed by internal auditors that meet the quality standards established by the Institute of Internal Auditors. Specifically there seems to be no reason why the auditors could not rely on walkthroughs, reviews of general IT controls and reviews of period end reporting if the work is properly performed by management and simply reviewed and tested by the auditor to establish the reliability of the work performed.

Question 23

Under Sarbanes Oxley, the audit committee is now the employer for the accountant. Having the accountant evaluate the effectiveness of the audit committee would constitute a violation of the independence concept. The audit committee looks to the accountant to provide independent insights into the Company and requiring the accountant to then evaluate the audit committee in an unbiased fashion seems to be an unreasonable expectation.

Question 27

The auditor report should comment on the effectiveness of management's assessment. If management offers an adverse opinion then having the accountant offer an adverse opinion seems confusing. An adverse opinion by the accountant in this case brings into question management's assessment process and suggests the possibility of additional undisclosed issues. If management has an acceptable assessment process and issues an adverse opinion and the accountant agrees that the assessment is properly performed and issues are properly disclosed, then the accountant should issue an unqualified opinion regarding management's assessment of controls.

Question 30

The quarterly Section 302 certifications are clearly management's responsibility. Under the certification, management is required to advise the auditor of significant deficiencies or material weaknesses. Neither the content of the certification nor the act suggests that additional work is required of the auditor each quarter. Audit review is only required under Section 404 on the annual report for internal controls. The requirement is to audit as of a point in time and evaluating controls at other dates would not be relevant to the annual attestation. The auditor role regarding quarterly certification in the proposed standard is beyond the expectations of the law.

Respectfully submitted;

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November 4, 2003

Office of the Secretary
Public Company Accounting Oversight Board
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PCAOB Rulemaking Docket Matter No. 008

Dear Mr. Secretary:

Please consider these comments on the proposed standard of the Public Company Accounting Oversight Board (PCAOB) entitled "An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Auit [sic] of Financial Statements" (Oct. 7, 2003) (the "Proposed Standard"). The comments are not geared discretely to any particular Question to which the PCAOB seeks responses, though they implicate Questions 1 and 26 set forth in the PCAOB's Release accompanying the Proposed Standard.

Summary. The Proposed Standard contemplates two separate audit opinions: a new one on internal control over financial reporting and the traditional one on financial statements. The Proposed Standard treats these exercises as integrated. The Proposed Standard also indicates it is possible to give a qualified or adverse opinion on one while giving an unqualified opinion on the other. This correctly implies that effective control is neither a necessary nor sufficient condition for fair financial reporting.1 It may be desirable for the Proposed Standard to make this reality express. Otherwise, there appears to be some risk that controls will come to be treated as ends in themselves rather than instruments to promote the ultimate end of fair financial reporting. There is also meaningful risk of confusion among investors and other users of financial data, control information, and audits of them.

1 If a company can have ineffective control and fairly-presented financial statements, then effective control is not necessary; if a company can have effective control but materially-misstated financial statements, then effective control is not sufficient. Neither point negates the possibility that some level of control is necessary nor that in certain discrete contexts some level of control is sufficient.

Analysis. The Proposed Standard states that an auditor can issue (1) a qualified or adverse opinion on the effectiveness of internal control over financial reporting but (2) an unqualified opinion that the financial statements fairly present results and condition in conformity with generally accepted accounting principles. *Proposed Standard, ¶¶ 177-79.* This seeming incongruity is possible because a material weakness discovered in internal control can be overcome in a financial statement audit by substantive tests that do not rely upon the control bearing the material weakness.

Consider the opposite situation. Can an auditor issue (1) a qualified opinion on the financial statements but (2) an unqualified opinion on internal control over financial reporting? The Proposed Standard does not address this situation. Nothing in logic, control or auditing standards prevents the possibility, however. Control over matters such as transaction recording, classification and aggregation may be air-tight but various judgments ranging from allowance for doubtful accounts to off-balance sheet financing to stock option valuation may still be aggressive. The possibility undercuts an implicit premise upon which the mandatory attestation of internal control project builds: If control is effective, then companies should not produce financial statements that cannot be given unqualified audit opinions. But this premise is false and the Proposed Standard could be improved by so stating.

The possibility of effective control producing materially misstated financial statements is recognition that effective control cannot guarantee fairly-stated financial statements. This is inevitable but somewhat obscured in the Proposed Standard. True, the Proposed Standard correctly emphasizes inherent limitations of internal control and the contrast between reasonable assurance, which is possible, and absolute assurance, which is not. *Proposed Standard, ¶¶ 15-17*. It likewise notes that the same limits of financial statement audits apply to control audits. *Proposed Standard, ¶ 17.* The Proposed Standard also rightly describes these limits as known features of the financial reporting process and expresses the hope that installing safeguards will "reduce, though not eliminate, the risk" of material financial misstatements. *Proposed Standard, ¶ 15.* But the particular context of providing a qualified or an adverse financial audit opinion despite furnishing an unqualified control audit opinion is never mentioned.

As matters of logic and probability, it may be more likely that a company will boast ineffective control and yet be in a position to present fair financial statements than the other way around. But of greater concern is the situation in which effective control nevertheless yields materially misstated financial statements. After all, this seems to have been the situation plaguing Enron Corp. and other catalysts of the Sarbanes-Oxley Act.[2] The possibility that effective control may nevertheless yield materially misstated financial statements therefore may warrant specific express attention in the articulation of auditing standards mandated by that Act.

2 *See* Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Might Just Work)*, U. CONN. L. REV., vol. 35 (2003), draft available on http://ssrn.com/abstract_id=337280).

Failure to draw express attention to this reality may produce investor confusion, particularly in light of rhetoric in pronouncements accompanying the Proposed Standard suggesting that incongruent opinions should not be possible. When the PCAOB released the Proposed Standard, for example, one Board member stated: "Reliable financial reporting would be impossible for a complex modern business without effective internal control." *Statement of Daniel L. Goelzer, PCAOB, Proposed Standard (Oct. 7, 2003)*. That opinion conflicts directly with the express statements in the Proposed Standard contemplating exactly the opposite situation.

Likewise, the Release accompanying the Proposed Standard states: "Effective internal control over financial reporting is essential for a company to effectively manage its affairs and to fulfill its obligations to investors." *PCAOB Release No. 2003-17 (Oct. 7, 2003), at 5*. If this were so, then it would not be possible to give a qualified or adverse opinion on control and an unqualified opinion on financial statements. The possibility of unqualified financial statement opinions with qualified or adverse control opinions means effective control is not essential, but the quoted sentence says it is essential. *See also Proposed Standard, ¶ 23* ("internal control over financial reporting . . . enhances the quality of financial reporting . . .").

The Proposed Standard describes itself as an integrated standard that refers to both audits of control and of financial statements. That interrelationship and the integrated standard evince a strong sense that it should not be possible to have ineffective control but fair financial statements or *vice versa*. Throughout the Proposed Standard, emphasis is laid on the interrelationship between the two types of audit. Sometimes the Proposed Statement indicates the direction of the relationship and sometimes does not.3 While the Proposed Standard draws from the interrelated character of the two audits the implication that an auditor cannot audit control without also auditing financial statements, there is also a false implication that effective control is the key to fair financial statements.4

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3 The Release accompanying the Proposed Standard refers to knowledge from financial audit informing the auditor's conclusions about the control audit. *PCAOB Release No. 2003-17 (Oct. 7, 2003), at 3*. Paragraph 26 of the Proposed Standard refers to deficiencies discovered in the control audit triggering adjustments to be made in the financial audit. It also indicates the two are interrelated. Paragraph 27 of the Proposed Statement states that knowledge gained from a financial audit informs auditors about control effectiveness. Paragraph 132 again describes the understandings obtained as interrelated, without expressing the direction of any relationship (control understanding from control audit is "interrelated with" control understanding gained in assessing control risk for a financial audit).

4 Oddly, the Proposed Standard also says the reverse is possible, that an auditor can audit financial statements without also auditing controls. The Proposed Standard gives as an example the case of an IPO, but does not explain how this illustrates the point. *Proposed Standard, at A-16, note 10*. Failure to clarify this could leave important obscurity in any final standard. As designed, the Proposed Standard permits performing financial audits giving unqualified opinions without the need to perform the control audit,

The Proposed Standard emphasizes that discovered financial misstatements may imply ineffective control but that their absence does not imply effective control. *Proposed Standard, ¶ 144.* Auditors of financial statements who discover misstatements are to be alert that this may signal ineffective control. *Proposed Standard, ¶ 143* ("The extent of such misstatements might alter the auditor's judgment about the effectiveness of controls"). This may lead the auditor to issue a qualified or adverse control opinion due to the time required to achieve effective control while issuing an unqualified opinion on the financial statements by first correcting misstatements.

But the Proposed Standard does not mention that ineffective control may not lead to financial misstatements nor that effective control may still produce financial misstatements. This asymmetry can create undue emphasis on control and insufficient emphasis on matters that must be valued by judgment. After all, everything about control over financial reporting is and should be geared to fairly-presented financial statements, not as ends in themselves.

This perspective generates a comment concerning Question 26 contained in the Release accompanying the Proposed Standard. It asks whether there are "circumstances where a qualified 'except for' conclusion [in a control audit] would be appropriate" as an alternative to expressing an adverse control-audit opinion when a material weakness exists. One possible circumstance is when the control material weakness did not prevent giving an unqualified opinion on the financial statements. Unless there is reason to believe that the material weakness in control will somehow prevent giving an unqualified financial statement opinion in a future period, there is no obvious purpose to giving an adverse control opinion in the current period.

A possible purpose is enhancing disclosure of the interior processes of financial reporting, control and audit. The contemplated regime pressures companies to reveal information concerning internal control. Adding an adverse auditor opinion on control effectiveness despite an unqualified opinion on financial statements strengthens this pressure. In giving an adverse control opinion, the Proposed Standard requires the auditor to disclose relevant material weaknesses.

As written, the Proposed Standard does not require disclosure of the auditor's processes or assessments during the control audit (or the financial statement audit). But if the value of providing an adverse (or qualified) control opinion despite an unqualified financial statement opinion is altering investors to impending adversity, logic suggests that the auditor fully disclose such risk and its processes and assessments concerning it. This result would forge a substantial change in the standards governing auditing

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but any auditor who performs a control audit must perform the financial statement audit where the Proposed Standard makes express the possibility of giving a qualified or adverse opinion.

practice,5 a position the public accounting profession has in the past successfully resisted.6

Some of the tension between different opinions in this integrated exercise may be due to two differences between what the Sarbanes-Oxley Act says and what the Proposed Standard contemplates (and addressing these may provide a way to reduce the tension). The first relates to Question 1 in the Release accompanying the Proposed Standard. It asks: "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?" The answer depends on what turns on the characterization.

Sarbanes-Oxley calls for an *attestation* of managerial assertions concerning control effectiveness, while the Proposed Standard contemplates prescribing an *audit* of such control effectiveness assertions. Though one footnote in the Proposed Standard suggests a modest and technical distinction between the two (designating audit as the process and attestation as the conclusion drawn), *Proposed Standard, A-8, note 3,* a number of statements in the Proposed Standard and accompanying release documents suggest a more significant difference.7 Using the term audit instead of attestation in the Proposed Standard may suggest a higher level of obligation and expected result compared to what the Sarbanes-Oxley Act contemplates. But the possibility of incongruent opinions in the two exercises shows any such higher level of obligation and result to be somewhat illusory.

Second, the Sarbanes-Oxley Act prescribes that the control attestation and the financial statement audit be performed by the same independent public accounting firm. *See* Sarbanes-Oxley Act, § 404(b) (providing that the control assessment not be a separate engagement from the financial audit). The Act does not specify that the two undertakings should have any other particular relation between them. The Proposed Standard expressly and firmly contemplates a close interrelationship between the two and articulates a standard expressing the goal of an integrated engagement for the two assignments.

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5 Such substantial changes may be behind one PCAOB Board member's statement that the coming regime of internal control certification and attestation "revolutionizes" managerial and auditor attention to internal control. *Statement of Daniel L. Goelzer, PCAOB, on the Proposed Standard (Oct. 7, 2003)*.

6 *See Monroe v. Hughes*, 31 F.3d 772 (9th Cir. 1994) (rejecting shareholder argument that public accounting firm had duty to disclose discovered internal control deficiencies or material weaknesses).

7 *See, e.g., Statement of Douglas Carmichael, Chief Auditor, PCAOB, on the Proposed Standard (Oct. 7, 2003)* (clarifying choice to use the term audit rather than attestation by explaining that financial statement audits are a form of attestation and that internal control assignments are similar). The presence of Question 1 in the Proposed Standard itself provides a basis to infer something more significant than semantics or technical characterization is at stake in the distinction between attestation and audit.

That integration suggests the two assignments are on par with each other in terms of level of obligation and expected assurance level. The public accounting profession has substantial experience with full-fledged auditing of financial statements that may enhance its capabilities and judgments honed from professional lessons. These are less likely to exist as to full-fledged auditing of control (as contrasted with the selected testing of controls in a financial statement audit). Aligning the obligation and expectations between the two types of assignments as the Proposed Standard contemplates may therefore be more ambitious than is reasonably justified, at least at present. Denominating the control assertion exercise as an attestation rather than an audit may be a way to recognize these differences.

Nor are these concerns directed solely at the potentially limited class of circumstances producing incongruent opinions. Consider the significance of a qualified opinion as to both control and financial statements or an unqualified opinion as to both. For joint qualified opinions, the alignment may signal to investors and others that control weaknesses are to blame for noncompliant financial statements. But this may not be the case. For joint unqualified opinions, the alignment may tend to create in the investment community a sense that control is working to the end of promoting fair financial statements. But this sense may be false.8

The stated purpose of effective internal control over financial reporting is to facilitate preparation of fairly-presented financial statements. But the possibility of incongruent audit opinions shows that there is no necessary connection between the two. In fact, the recognized possibility of incongruent opinions suggests reason to be concerned that control can become an end in itself rather than the means to the ultimate objective of fair financial reporting.9 To the extent possible, it would seem desirable for the Proposed Standard to be modified to neutralize this concern.10

Sincerely yours,

Lawrence A. Cunningham
Visiting Professor of Law, Vanderbilt University
Professor of Law & Business, Boston College

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8 This raises another comment, concerning Example A-2. This example shows an adverse audit opinion when management's assessment is that its company did not maintain effective internal control. If management says its company did not maintain effective internal control, users do not need an auditor to attest to this assertion.

9 *See* Lawrence A. Cunningham, *The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism, Other Ills*, JOURNAL OF CORPORATION LAW (UNIVERSITY OF IOWA), vol. 29 (forthcoming 2004) (available at http://ssrn.com/abstract_id=444600).

10 To minimize forecasted investor confusion, consideration might be given to including illustrations of circumstances that could produce incongruent opinions.

DEFENSE CONTRACT AUDIT AGENCY
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OFFICE OF THE DIRECTOR

PAS 730.3.B.2.4 November 21, 2003

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

SUBJECT: PCAOB Rulemaking Docket No. 008 Proposed Auditing Standard - An Audit of Internal Control Over Financial Reporting

Members and Staff of the Public Company Accounting Oversight Board (PCAOB):

The Defense Contract Audit Agency (DCAA), under the authority, direction, and control of the Under Secretary of Defense (Comptroller) is responsible for performing all contract audits for the Department of Defense (DoD), and for providing accounting and financial advisory services regarding contracts and subcontracts to all DoD Components responsible for procurement and contract administration. DCAA provides a wide variety of products and services to contracting officers including independent attestation audits of defense contractors' internal control systems. Many of the largest DoD contractors that DCAA audits are publicly traded and therefore would be required to implement the standards issued by the PCAOB.

DCAA audits are conducted in accordance with Generally Accepted Government Auditing Standards (GAGAS) which incorporate American Institute of Certified Public Accountants (AICPA) standards. The GAGAS also prescribe additional field work and reporting standards. DCAA makes every effort to exceed the minimum requirements of the standard setting bodies in providing timely and responsive audits, reports, and financial advisory services to DoD contracting officers and other customers. In addition, a significant percentage of DCAA auditors are certified public accountants.

With regard to the proposed standard on internal control audits, in many areas, DCAA auditing procedures mirror the proposed standard. At the largest DoD contractors, DCAA performs attestation engagements of the 10 internal control systems that most affect Government contracts (for example, billing systems). We believe that audit work performed by DCAA is a quality product, distinguished by the Agency's independence, integrity, and objectivity. As such, we are providing comments on the Board's question number 12 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?*

Paragraph 5 of the proposed standard states that auditors obtain reasonable assurance by evaluating the assessment performed by management and *others under the direction of management* (emphasis added). Paragraph 41 further directs the auditor to evaluate management's process for assessing the effectiveness of the company's internal controls including determining which controls in the process should be tested. The controls and evaluation criteria listed under paragraph 41 of the proposed PCAOB standard are an integral part of DCAA's fundamental requirements and responsibilities for obtaining and documenting an understanding of a contractor's internal controls, assessing control risk, and determining which controls should be tested.

If the extensive and independent testing of internal controls performed by DCAA is any guide, we believe that it is possible that other governmental audit organizations at the Federal or state levels may also produce audit work that meets the standards necessary to warrant reliance by the independent public accountants that are reporting on companies' internal controls over financial reporting.

Consequently, we recommend that the proposed standard be revised to allow audits of internal controls performed by government audit agencies to be included among management's potential sources of reliance. We believe strongly that if CPAs can consider the work of management and management-directed organizations in assessing the firm's internal controls, the CPAs can also consider audit work performed by independent third parties such as government auditors who have no potential conflicts of interest. Limiting the sources of reliance to only those internal to the firm potentially ignores a considerable body of relevant work performed by independent third parties, and could result in duplication of effort and increased audit costs.

Using the Defense Contract Audit Agency (DCAA) as an example, we find that:

- DCAA performs its audit for third party requestors, is not paid by or under the control of management, and is therefore unquestionably independent.
- DCAA's audit guidance for examining internal controls is based on the guidance published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The proposed standard is also based on the COSO framework.
- It is DCAA's policy that each relevant accounting or management system that has a significant impact on Government contract cost be audited on a cyclical basis.
- DCAA audits examine relevant assertions, express an opinion, and report on all significant deficiencies.
- All DCAA audits include consideration of the assessment of the risk of material misstatement due to fraud.

- Defense contractors routinely place reliance on DCAA accounting and management system (internal control) reports as a means of verifying and validating that controls in place are functioning as intended, and of implementing corrective actions, when controls are not functioning or could be improved.

Finally, we noted that the Board's summary discussion and the proposed standard's text in paragraph 5 and paragraph 104 regarding "Using the Work of Management and Others" is inconsistent. Paragraph 5 specifically refers to the work of "others under the direction of management", while Paragraph 104 states "others" with no reference to management. Are "Others" in the context of paragraph 104 limited to those groups under the control of management as indicated by paragraph 5 or does it also encompass others that are outside of the scope of management's control, such as government agencies, as we recommend?

We appreciate the opportunity to provide comments on the proposed auditing standard on an audit of internal control over financial reporting performed in conjunction with an audit of a financial statement. Questions or comments regarding this commentary should be addressed to Ms. Deaune C. Volk, Program Manager, Auditing Standards Division, at (703)767-3233 or Ms. Mary L. Silva, Chief, Auditing Standards Division, at (703)767-3220.

/Signed/
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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
Proposed Auditing Standard: An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

Deloitte & Touche LLP is pleased to respond to the request for comments from the Public Company Accounting Oversight Board (the "PCAOB" or the "Board") on its Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, PCAOB Rulemaking Docket Matter No. 008 (the "Proposed Standard") (October 7, 2003), to implement Sections 103(a)(2)(A) and 404 of the Sarbanes-Oxley Act of 2002 (the "Act"). Overall, we are very supportive of the Proposed Standard, and we recognize the efforts of the PCAOB in its development and commend many aspects of it.

While we agree with the overall approach of the Proposed Standard, we also believe there are many issues that must be addressed to permit the standard to be applied and implemented consistently and in a manner that meets the objectives of the Board and the Act.

We strongly agree with the position of the Board with respect to the need for the auditor to audit the effectiveness of internal control rather than solely evaluate management's assessment process. Overall, we believe the scope of the work described for the auditor generally is appropriate but will be subject to wide variations in interpretation, especially in relation to the extent of the walkthroughs, the degree of reliance that can be placed on the work of others, and the implications of company-level controls. We have concerns about the extent to which the requirements in the standard also apply to management's assessment, in particular with respect to the extent of management's documentation and testing.

We have organized our comments into three sections as follows: (I) Overall Comments, (II) Comments Related to Certain Paragraphs, and (III) Responses to Specific Questions.

I. OVERALL COMMENTS

1. Decision Mandating the Auditor to Audit the Underlying Controls as Well as Management's Assessment Process

We believe the aspect most critical to the achieving the purpose of the Act is the decision by the Board to require the auditor to test the effectiveness of internal control over financial reporting as well as evaluate management's assessment process to meet the objective of expressing an opinion about whether management's assessment is fairly stated. This decision, in our view, is in the best interests of investors, who will expect the independent auditor to obtain independent evidence as to whether the public company's internal control over financial reporting is effective, rather than solely evaluating management's process and evidence.

2. Increase the Focus on Areas With the Highest Risk of Material Weaknesses in Internal Control Over Financial Reporting

A study released by the GAO in 2002[1] indicates that the majority of financial restatements of companies relate to nonroutine, complex areas such as revenue recognition, corporate restructurings, and accounting for acquisitions. The risks of material misstatement associated with these areas are not easily mitigated by process-level control activities. The Proposed Standard appears to focus more on the control activities component of the COSO framework, including process-level control activities, than the more judgmental and high-risk areas, such as the control environment, risk assessment, and monitoring. For example the Proposed Standard provides very detailed guidance for identifying and considering the controls related to the significant accounts and processes, many of which, while significant, are typically routine in nature. This focus also is illustrated by the examples provided in Appendix D of the Proposed Standard.

We recognize the Board's attempt to address the more judgmental areas, such as the control environment, as illustrated by guidance on the evaluation of the effectiveness of the audit committee's oversight role. However, we believe that, overall, the Proposed Standard should provide more guidance on the key risk areas such as the control environment; the significant nonroutine, nonsystematic, and period-end financial reporting processes; and the company's risk assessment and monitoring processes to help focus both management's and the auditor's evaluation of internal control over financial reporting on areas of greatest potential risk of material misstatement of the financial statements. For example, the Board's current discussion of risk assessment focuses solely on the transactional level and does not specifically address the entity-level risk assessment process. Such an assessment should specifically consider, for example, the evaluation of the risk of fraud, including the risk of management override, and the company's antifraud programs and controls, including the company's need to identify and review unusual and significant journal entries—areas where most companies have not traditionally focused their efforts.

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[1] U.S. General Accounting Office. *Financial Statement Restatements—Trends, Market Impacts, Regulatory Responses, and Remaining Challenges* 03-138. Washington, D.C., October 4, 2002.

Also, given the increasing importance of fair disclosures, the Board should consider providing guidance relating to the identification and evaluation of control deficiencies that have an adverse effect on the presentation and disclosures assertions.

3. Management's Responsibilities

The Proposed Standard, while establishing requirements of the auditor, also establishes requirements of management (e.g., paragraphs 41-47 in the Proposed Standard). However, throughout the Proposed Standard there are numerous specific requirements established for the auditor that are not explicit for management to consider in paragraphs 41-47. An example is paragraph 57, related to the evaluation of the effectiveness of the audit committee. Additionally there are a number of places within the Proposed Standard where it is unclear whether the guidance applies only to the auditor or to management's assessment as well. For example, in paragraph 55, are company-level controls alone not sufficient for the purpose of management supporting their assessment? In paragraph 126, is it the Board's intent that if the company's internal control identified a fraud of any magnitude on the part of senior management, that would be a strong indicator of a material weakness for management's assessment purposes or does this apply only if the auditor identifies the fraud? Another example is paragraph 144. These are all indicators that a framework, requirements, and guidance should be sufficiently established to describe management's assessment process before auditing standards can be appropriately implemented.

While we agree with the Board that management's assessment must meet the various requirements currently embedded in various sections of the Board's Proposed Standard, including paragraphs 41 through 47, we do not believe the Proposed Standard is the best medium to establish the requirements that management must follow. We encourage the Board to work with the SEC to improve the appropriate evaluation framework, requirements, and guidelines that management should follow in preparing its assessment of internal control over financial reporting. We believe that paragraphs 41-47 of the Proposed Standard represent a good starting point that should be expanded to provide an adequate base for management's evaluation process that will be consistent with the auditor's process. In the course of establishing such guidelines, the Board and the SEC should consider harmonizing differences that currently exist between the definitions of significant deficiency and material weakness in the Proposed Standard and the definitions in the SEC's final rule on Section 404 of the Act. Otherwise, auditors and management might use different definitions to evaluate control deficiencies identified in the audit and assessment, respectively.

Nevertheless, we believe the Board should clarify its guidance relating to the management's responsibilities in the following areas.

a. Management's Assessment Process

The Proposed Standard focuses on procedures that the auditor should follow with respect to significant accounts, major classes of transactions, and other items of importance. It does not provide similar guidance for management in terms of their documentation requirements and assessment process**.** Nor is it clear what should be considered with respect to the insignificant accounts, minor classes of transactions, and other items, which are of lesser importance but are important when considered in the aggregate. We recommend that the Board provide such clarification in paragraphs 41-47 regarding management's responsibilities, including guidance with respect to identifying significant accounts, processes, locations, and those accounts that remain after the significant and important ones have been addressed.

We also strongly urge the Board to provide guidance relating to the testing by management to promote consistency and to clarify the confusion that exists between evidence that may be derived from a self-assessment process as opposed to independent testing. Companies are seeking specific guidance in terms of: (1) the appropriateness of evidence, including nature, extent and format, from a self-assessment process and (2) the nature, extent, and timing of independent testing by internal audit or by others under the direction of management, presumably to verify that the self-assessment process has integrity.

b. Extent of Documentation

The Board's Proposed Standard discusses two aspects of documentation. One relates to management's documentation of its assessment of the effectiveness of internal control over financial reporting ("documentation of management's assessment"), and the other relates to the documentation of the underlying control procedures and responsibilities for internal control within the company ("documentation of the design of internal control"). As established in paragraph 45, the documentation of the design of internal control is important for purposes of communicating responsibilities and providing a foundation for monitoring the effectiveness of internal control (e.g., to apply company-level controls).

There is confusion over management's responsibilities and the resulting implications on management's and the auditor's reports. For example, some companies are interpreting the Proposed Standard as suggesting that they do not need to document the design of internal control at locations that are insignificant individually or in the aggregate because they are documenting and testing company-level controls**.** However, without adequate documentation, monitoring activities, such as company-level controls, are unlikely to be effective, as the control will not be consistently understood and accountability will not have been clearly established. Additionally, in paragraph 46, the Proposed Standard adds further confusion by providing that "in evaluating the deficiency as to its significance, the auditor should determine whether management can demonstrate the monitoring component of internal control over financial reporting in the absence of documentation," Accordingly we believe the last sentence in paragraph 46 should be deleted. Further, we recommend that the Board clearly establish management's responsibility with respect to maintaining company-wide internal control documentation.

We agree that the lack of adequate documentation of the design of internal control is a deficiency in internal control over financial reporting, the significance of which should be determined first by management in preparing its assessment and then by the auditor in performing their evaluation.

However, if the auditor concludes that there is insufficient documentation of management's assessment, paragraph 20 requires the auditor to disclaim an opinion, with which we agree. The auditor also should consider whether the insufficient documentation also identifies a deficiency in the documentation of the design of internal control that is judged to constitute a material weakness, in which case the auditor should be directed to issue a report with an adverse opinion as opposed to a disclaimer (please refer to our separate comment in Section 2 regarding paragraph 20).

Accordingly we recommend the following to replace Paragraph 47 (assuming the guidance in paragraph 20 is modified).

> If the auditor concludes that the documentation of management's assessment is insufficient to support management's evaluation of the operating effectiveness of internal control, the auditor should also consider whether there is inadequate documentation of the design of internal control that constitutes a material weakness and follow the guidance in paragraph 20.

c. Consideration of Extended Relationships

Aside from consolidated entities and other financial interests accounted for as investments, companies engage in an increasing number of relationships, which have a direct impact on their financial reporting. These range from the outsourcing of software applications, application hosting, and in some cases, a portion to all of the financial transaction processing and financial reporting processes. It is unclear whether the guidance in Appendix B of the Proposed Standard with respect to SAS 70 and the use of service organizations also applies to management. We strongly recommend that paragraphs 41-47 be expanded to indicate explicitly the other paragraphs that management also should incorporate in its assessment, such as the guidance in Appendix B related to service organizations.

4. Issues Regarding the Scope of an Audit of Internal Control Over Financial Reporting

a. Significant Accounts

The Proposed Standard provides that a significant account may be identified at a number of different levels including (1) the financial statement line item level, (2) the account or account balance, which is not defined but is referred to in paragraphs 61 and 62, and (3) the account component level, which suggests it is a subset of an account balance in paragraph 62. Identifying significant accounts at multiple levels is likely to create confusion and, thus, we suggest that the identification of a significant account occur only at the account balance level.

To simplify this structure, we suggest that the standard begin by identifying all "significant" financial statement line items and disclosures. A line item or disclosure should be considered significant if there is a more than a remote likelihood that the financial statement line item or disclosure could contain misstatements that could result in a material effect on the financial statements, considering the risk of both overstatement and understatement. The assessment of a more than remote likelihood should be made without giving any consideration to the effectiveness of internal control. We would expect that virtually all financial statement line items and disclosures will be considered significant.

Next, within those financial statement line items and disclosures, account balances should be determined by aggregating general ledger accounts that have similar risks and share common processes and controls and by disaggregating those general ledger balances that have differing risks and controls. The account balances should be evaluated to identify significant accounts based on materiality and a more than remote likelihood the account balance could contain misstatements that could result in a material misstatement to the financial statements including both understatement and overstatement considerations. Additionally, accounts that are not material may also be identified as a significant account taking into consideration qualitative factors such as those listed in Paragraph B17 and the expectations of a reasonable user as presented in Paragraph 61. Again, the assessment of a more than remote likelihood should be made without giving any consideration to the effectiveness of internal control.

The intent of paragraph 61 of the Proposed Standard is unclear to us in terms of the aggregation consideration. Is it intended to aggregate virtually all the accounts and disclosures that do not meet the definition of a significant account? This results in a scope that, in our view, is too broad and impractical. Accordingly, clarification is needed. The accounts and disclosures that were not identified as a significant account should be aggregated. If material in the aggregate, the key control(s) over this group of account balances (e.g., an effective monitoring control such as reconciling the account on a monthly basis) should be identified and documented. The rationale for focusing on the monitoring control is that the processing-related controls in these individually insignificant accounts generally are not the important controls. The detective and general controls, such as the monitoring, segregation of duty, and financial reporting controls, generally are the important controls to focus on for these individually insignificant accounts. The tests of design and operating effectiveness should focus on determining that the key control(s) had been placed in operation and is operating effectively by sampling from the group of such account balances and disclosures on a test basis.

Paragraph 63 of the Proposed Standard implies that the identification of potential significant accounts is performed on a location-by-location basis. However, it is not clear how this should be applied when considered in conjunction with the multiple location guidance in Appendix B. Further guidance and an example will enhance consistency in application of this guidance.

b. Performance of Walkthroughs

We agree that the performance of walkthroughs should be required for all of the company's significant processes as indicated in the Proposed Standard. We also agree that it is appropriate to require that the auditor perform the walkthroughs to ensure that the auditor has a sufficient understanding to plan their work. However, we have six concerns with regard to certain aspects of the proposed requirements.

First, the standard should clarify the following with regard to the walkthroughs:

- Whether the term "significant process" referred to in paragraph 79 is the same as the "significant processes" referred to in paragraph 69.

- The relationship between "types of transactions" in paragraph 79 and "major classes of transactions" in paragraph 69. Also, providing examples of "types of transactions" and "major classes of transactions" would be helpful.

Second, depending on the clarifications of the terms above, the scope of the walkthroughs as proposed in paragraphs 79 and 80 may be interpreted by some as overly broad and expansive. Paragraph 79 states the following:

> The auditor should perform a walkthrough for **<u>all</u>** of the company's **<u>significant processes</u>**. In a walkthrough, the auditor should trace **<u>all types</u>** of transactions and events, both recurring and unusual, from origination through the company's information systems until they are reflected in the company's financial reports**.** Walkthroughs provide the auditor with evidence to . . . confirm that the auditor's understanding of the process is complete by determining whether **<u>all points</u>** in the process where misstatements related to each relevant financial statement assertion that could occur have been identified.

We agree with the desire of the Board for the auditor to identify and consider the unusual and infrequent types of transactions that may occur within a "significant process." However, the concept of tracing all types of transactions is inconsistent with the guidance the Board provides in paragraphs B12 and B13 of Appendix B relating to locations, which allows for consideration of materiality and risk. We agree with the guidance contained in Appendix B, and we recommend that paragraph 79 be modified to incorporate a similar concept.

Third, paragraph 80 also states that the walkthrough should "encompass the **<u>entire process</u>** of initiating, recording, processing, and reporting individual transactions, and controls for all five internal control components and fraud, not just control activities." Based on this language, it is not clear which processes and transactions are required to be covered by the walkthrough. Paragraph 80 should be clarified such that the walkthrough relates only to those processes identified in paragraph 69, not all processes within the company. Further, the combining of the five internal control components may cause confusion, because many of them are pervasive in nature and do not relate directly to transactional processing. Accordingly, we recommend revising the first sentence in paragraph 80 to read as follows:

> The auditor's walkthroughs should encompass the entire process of initiating, recording, processing, and reporting individual transactions, and controls for each of the significant processes identified. Additionally, the auditor should gain an understanding of the Company's internal control related to the control environment, risk assessment, monitoring, and information and communication components.

Furthermore, the extent of walkthroughs should vary depending upon a number of factors including the nature of the transaction, complexity, and exposure to loss, particularly relating to the more insignificant types of transactions. We believe these factors should be set forth in the standard.

Fourth, also in paragraph 80, the phrase "controls for all five internal control components and fraud" implies that fraud controls are something separate and distinct from controls for the five internal control components. In our view, fraud is an important consideration with respect to each of the five internal control components and, thus, the word "and" should be replaced with "including."

Fifth, paragraph 82 states that "when there have been significant changes in the process flow of transactions, including the supporting computer applications, the auditor should evaluate the nature of the change(s) and the effect on related accounts to determine whether to walkthrough transactions that were processed both before and after the change." This language seems to indicate that it is optional as to whether the auditor should understand the changes that have occurred. For any significant changes to the significant processes that impact controls over financial reporting, we believe that the auditor should walkthrough transactions that were processed after the change. Additionally, if there has been a significant change, we do not believe it is necessary to perform procedures prior to the change. Moreover, the auditor may not be aware of the change until after it has occurred. Therefore, paragraph 82 should be modified to state that "when there have been significant changes in the process flow of transactions, including the supporting computer applications, the auditor should evaluate the nature of the change(s) and the effect on related accounts and transactions. Additionally, for significant changes in the significant processes that impact controls over financial reporting, the auditor should walkthrough transactions that were processed after the change."

Sixth, in paragraph 83, the guidance only refers to nonroutine and estimation processes. We believe this is guidance is applicable for <u>all</u> processes for which a walkthrough is performed and that the Proposed Standard should so state.

c. Company-Level Controls

We agree with the Board's position in paragraph 54 of the Proposed Standard that company-level controls have a pervasive effect on controls at the process, transaction, or application level. However, we believe further clarification is needed pertaining to certain elements of company-level controls.

First, we believe that further discussion is warranted to clarify that the purpose for evaluating company-level controls is to understand, evaluate, and test the effectiveness with which these controls are applied across locations or business units. The separation of company-level controls as discussed in paragraphs 53-55 from the multiple location guidance contained in paragraphs B4, B8, and B9 of Appendix B creates confusion. Accordingly, the Proposed Standard should clarify that company-level controls are important to consider when determining the locations that management and the auditor should include in its scope. Further clarification also is needed to indicate that the controls presented are illustrative and are not intended to be a complete list of company-level controls nor is a company required to have all the controls in the list to support its assessment of effective company-level controls. However, ineffective company-level controls may be a serious deficiency that will affect the scope of the work performed at the locations.

Second, we suggest clarifying in paragraph 53 that the listing of company-level controls presented are not suggesting that only these controls need to be considered to address the components of the COSO framework but that these controls represent part of one or more of the five components of the COSO framework.

Third, to support that company-level controls are effective at multiple locations, there should be evidence that the relevant controls had been documented and communicated at these locations.

Accordingly the Proposed Standard should state:

> A foundation for the entity-wide controls is the significant controls at the location or business unit. Therefore, these significant controls also should be documented by [management].

Fourth, paragraph B9 of Appendix B states, "The auditor should perform tests of company-level controls to determine whether such controls are operating effectively. The auditor might conclude that he or she cannot evaluate the operating effectiveness of such controls without visiting some or all of the locations or business units." We believe that the term "might conclude" does not adequately state that the auditor (and management) has a responsibility to test company-level controls at some locations. We believe that the Board should be specific in Appendix B regarding performing company-level controls at multiple locations.

d. The Auditor's Use of the Work Performed by Management and Others

We agree with the Board that the auditor should be permitted, but not required, to use the work of management or others. Nowhere else in professional literature is the auditor required to use the work of management or others. We believe that the scope of the auditor's work should be determined by the auditor. However, we also believe that further guidance is needed with respect to certain items in paragraphs 103-109 of the Proposed Standard pertaining to the auditor's use of the work performed by management and others.

First, the Proposed Standard separates work performed by management into three categories. However, it is not clear how the auditor's ability to use the work of management and others reconciles with the requirement that the auditor obtain the "principal evidence" to support its opinion. The Board should clarify how these two concepts work together.

Second, we believe that some may interpret the language in paragraphs 103-109 as a means to inappropriately minimize the level of effort on the part of the external auditor to test the effectiveness of internal control. That is, auditors may conclude that they only need to independently test those areas in which the auditor is not permitted to use management's procedures (paragraph 104) and those areas in which the auditor's use of management's procedures should be limited (paragraph 105). We believe the unintended consequence is that auditors will not perform any of their own tests in regard to the largest category of controls – controls over routine processing of significant accounts and disclosures (paragraph 106). This will result in over-reliance on work performed by management and internal audit. We recommend that in addition to performing tests in those areas designated in paragraphs 104 and 105, the auditor also be required to perform some independent tests of controls over routine processing of significant accounts and disclosures (paragraph 106).

Third, as proposed, auditors are required to reperform "some" of the tests of controls performed by others. We recommend that additional guidance be provided with respect to the meaning of "some" in the context of the areas where the auditor's reliance on the work of management and others should be limited (paragraph 105) and where there is no specific limitation (paragraph 106). We suggest that the Board develop examples for illustration in the appendix.

Fourth, we are concerned that auditors may use the work performed by management not only to satisfy the audit of internal control over financial reporting but also to reduce the level of substantive testing related to the financial statement audit. We do not believe this is the intention of the Board. For financial statement audit purposes, we believe that the auditor should continue to follow the guidance of SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*. However, the Proposed Standard does not set any limitations with respect to the auditor's ability to reduce substantive testing. Therefore, how the Proposed Standard and SAS 65 interrelate should be clarified.

Fifth, paragraph 104 of the Proposed Standard states that the areas in which the auditor should not use the work of others include "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." Many companies have an internal staff that is well qualified to perform IT general control work. We believe that testing of IT controls should be moved from the category where the auditor should not use the work of others to the category where the use of the work of others should be limited.

e. General Computer Controls

We suggest that the Board provide more explicit guidance on the types of general computer controls that fall within the definition of internal control over financial reporting versus operational effectiveness and efficiency. For example, we believe that business continuity and disaster recovery, while an important operational control, is not a component of internal control over financial reporting, except to the extent that they relate to the recovery of data to achieve the objective to maintain records.

f. Safeguarding of Assets

While we agree that additional guidance on what is meant by safeguarding of assets is helpful and important, we believe that Appendix C of the Proposed Standard should be significantly enhanced. Appendix C should be specifically linked to the definition of safeguarding of assets set forth in paragraph 6 of the Proposed Standard. It also is not clear how the guidance in Appendix C relates to the COSO Addendum, *Reporting to External Parties*, which is referred to in the SEC's Final Rule for Section 404. The guidance in paragraph C1 also should be specifically linked to the definition in the COSO Addendum.

As proposed, Appendix C does not sufficiently answer which controls over safeguarding of assets are within the scope of internal control over financial reporting and which are not. For example, assume that a company has safeguarding controls over inventory such as inventory tags (preventative controls) and that the company also performs periodic physical inventory counts (detective control) timely in relation to their interim and annual financial reporting dates. Although the physical inventory count does not safeguard the inventory from theft or loss, it prevents a material misstatement to the financial statements if performed effectively and timely. Therefore, given that the definitions of material weaknesses and significant deficiencies relate to the likelihood of misstatement of the financial statements, the failure of a preventive control such as inventory tags will not result in a significant deficiency or material weakness because the detective control (physical inventory) prevents a misstatement of the financial statements.

The COSO Addendum also indicates that a company does not have to consider preventive controls over inventory shrinkage if it has sufficient detective controls to measure and record any shrinkage on a timely basis. If the Board intended to extend safeguarding of assets beyond financial reporting (e.g., the ineffectiveness of the inventory tags to prevent inventory theft or loss illustrated above), then the Proposed Standard should indicate areas that management and the auditor should include in safeguarding of assets, and the definitions of significant deficiencies and material weaknesses will need to be modified to address safeguarding controls.

Also, the first two examples and, perhaps, the fourth example in paragraph C1 of the Proposed Standard arguably may not result in a misstatement of the financial statements and, therefore, seem problematic from a definitional perspective. The intent of the fourth bullet is not clear, because ultimately all costs impact pricing decisions, which seems to sweep in improper allocation as a consideration for all cost categories. We suggest clarifying that this relates only to programs whereby costs are directly recovered from customers. Examples would be helpful to ensure proper application.

Finally, Appendix C categorizes all of the bulleted items as "unintentional misstatement." While some situations may be unintentional, the misappropriation of assets generally is intentional.

5. Reporting

a. Requirement to Issue an Adverse Opinion in Certain Circumstances

The Proposed Standard requires the auditor to render an adverse opinion when a material weakness is identified. An adverse opinion concludes with the opinion that due to the effect of the material weakness on the achievement of the objectives of the control criteria, the company has not maintained effective internal control over financial reporting. We strongly disagree with this approach. We believe that the auditor should render the appropriate type of opinion based on the circumstances that caused the material weakness. This approach would provide better information about the nature and impact of the material weakness identified.

While we agree that material weaknesses that are pervasive to the company should result in an adverse opinion, we also believe that an adverse opinion is not appropriate if the material weakness is not pervasive. For example, a company with effective internal control might make an acquisition of a business that has a material weakness. Users of the report should be permitted to understand whether the material weakness relates only to the acquisition or has a more pervasive impact. A qualified opinion best communicates this situation. The Proposed Standard should be modified to provide for flexibility in evaluating the material weakness based on significance to the entire company and should permit the auditor to issue either an adverse or a qualified "except for" opinion, depending on the circumstances.

In addition, we are concerned that a scope limitation will not adequately inform the public in situations where a material weakness has been identified and corrective action has been taken but insufficient time has passed to determine whether the material weakness has been corrected. In such cases, the auditor should conclude that management's assessment is inadequate, leading to a modification of the auditor's report due to the existence of a material weakness. If the Board decides that such cases should result in a scope limitation, then the standard should require descriptive language of the scope limitation that includes a description of the material weakness and a statement that if such weakness were not corrected, the auditor could not conclude that internal control is effective.

This scenario further supports the need for clear guidance as to what constitutes a "sufficient period" in paragraph 166 of the Proposed Standard. The relevance of evidence subsequent to the "as of" date should be explicitly addressed. In our view, in the case of a deficiency in the design of internal control, there must be substantive evidence that the control had been implemented prior to the "as of" date sufficient to correct the deficiency. Accordingly, failure to implement adequate controls at the "as of" date is a deficiency without regard to any corrective action that may have been taken after the "as of" date. However when there is not a sufficient period of time to obtain adequate evidence about the operating effectiveness of the new control prior to the "as of" date, then we believe that management and the auditor may consider evidence subsequent to the "as of" date, but before the date of the auditor's report as to whether the control was operating effectively. If such sufficient evidence cannot be obtained, then the condition results in a deficiency as opposed to a scope limitation.

We recommend providing examples of illustrative language disclaiming an opinion on disclosures about corrective actions taken by the company and the company's plans to implement new controls (the first two bullet points of paragraph 174).

b. Explanatory Footnotes to Management's and the Auditor's Reports

Similar to the preparation and audit of the financial statements, an assessment and audit of the effectiveness of internal control involve a number of important considerations. When reading the financial statements, an understanding of the important aspects, which can range from critical accounting policies to segment and other disclosures, is crucial in providing the reader with the proper context to evaluate the financial statements presented. Similarly, we believe information relevant to assisting users to better understand management's assessment and the auditor's evaluation of the effectiveness of internal control over financial reporting should be disclosed in management's report on internal control. We believe that relevant information includes (1) disclosure of what management included in safeguarding of assets, (2) the entities excluded from the scope of management's evaluation (whether or not consolidated) such as provided in paragraphs in B15 and B16, and (3) the nature and extent of the use of service auditor reports as the basis for its assessment relating to outsourcing and other service relationships.

Currently, when relying on the work of other auditors the auditor is able to apportion responsibility in their report. Yet under SAS 70, neither management nor the auditor makes reference in their report to the use of the service auditor's report. SAS 70 was designed for an audit of the financial statement whereby the auditor is also required to perform his or her own substantive tests and, thus was not relying exclusively on the service auditor's report. However, for purposes of the audit of internal control, neither management nor the auditor is required to perform any additional procedures. Therefore, the only evidence with respect to the service organization's controls comes from the evaluation and testing performed by the service auditor. Accordingly we believe that the reliance on a service auditor should be clearly disclosed in management's and the auditor's report to provide transparency as to the source of the evidence.

We believe it is important for users of management's report and the auditor's report to understand the boundaries of the internal control being reported on, in terms of entities covered and not covered. We do not believe that a narrowing of the boundaries should be discussed as a limitation in scope but rather as a means to clarify the boundaries of the company's internal control over financial reporting that their respective reports cover.

6. Evaluating the Effectiveness of the Audit Committee's Oversight

a. Effectiveness of the Audit Committee as an Element of the Control Environment

We agree with the Board's emphasis on the importance of the effectiveness of the audit committee. The audit committee plays an important role in setting the "tone at the top" and providing an important oversight function with respect to financial reporting. Although some may take the view that the effectiveness of the audit committee is outside the scope of the company's internal control over financial reporting, the COSO framework has long recognized the effectiveness of the audit committee as one of the elements of the control environment. However, we expect that the Proposed Standard's requirement will be controversial and difficult to implement. Accordingly, the Proposed Standard should be changed to reflect the effectiveness of the audit committee as an important aspect of the control environment, rather than what appears to be a separate evaluation. In addition, we believe this requirement contains elements that should be significantly changed.

First, the Proposed Standard does not make clear whether management's assessment is required to also include an evaluation of the effectiveness of the audit committee's oversight. Keeping with the construct of the audit of internal control (i.e., management first makes its assessment and then the auditor evaluates and tests that assessment), we believe that management (in conjunction with the Board or the audit committee itself) also should be required to evaluate the performance and effectiveness of the audit committee's oversight considering the requirements set forth for auditors in the Proposed Standard. This requirement is consistent with Section 407 of the Act, whereby boards of directors are required to determine whether members of the audit committee are financial experts. Additionally, newly adopted listing exchange standards require that an annual assessment of the audit committee be performed.

Second, ordinarily the auditor does not have full and complete access to the audit committee. Without full and complete access, the auditor will be unable to identify all of audit committee's activities, interactions with other parties, and conclusions reached. Therefore, we do not believe that the auditor will have available all of the information needed to effectively perform its evaluation and will be unable to adequately assess the effectiveness of the audit committee against the specific requirements of paragraph 57 of the Proposed Standard unless it has full and complete access to the audit committee. We believe that the Board needs to provide guidance as to how this issue should be addressed.

b. Factors Related to the Evaluation of the Audit Committee's Oversight

The Board has provided a list of factors in paragraph 57 of the Proposed Standard for auditors to consider related to the evaluation of the effectiveness of the audit committee's oversight. For the auditor to carry out this responsibility effectively, we believe certain of the listed factors need to be more specific while others should not be included in the list.

First, testing for compliance with laws and regulations, such as applicable listing standards implemented as a result of Section 301 of the Act, is outside the scope of internal control over financial reporting. The SEC rule, *Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, defines internal control over financial reporting, and this definition, as stated in the SEC's rule, "does not encompass the elements of the COSO definition that relate to the effectiveness and efficiency of a company's operations and a company's compliance with applicable laws and regulations, with the exception of compliance with the applicable laws and regulations directly related to the preparation of financial statements, such as the Commission's financial reporting requirements."[2] We do not believe compliance with applicable listing standards adopted pursuant to Section 301 of the Act is directly related to the preparation of the financial statements. Therefore, we do not believe this aspect of evaluating the audit committee should be encompassed with the audit of internal control over financial reporting.

Second, the definition of "independence" should be specifically identified so that the same criteria are applied for all evaluations of audit committees. Moreover, it is unclear how an auditor can reasonably evaluate whether the nominating process for the audit committee is appropriately independent or whether management picks "friends."

In response to Question 24 of the Board's request for comments on specific questions, we do not believe that it is in the interest of investors or the public to require the auditor to withdraw from the audit engagement because the auditor has concluded that the audit committee is ineffective. If the auditor is able to form a conclusion regarding the effectiveness of internal control over financial reporting, which includes the assessment of the audit committee, then the auditor should issue the appropriate report. Ineffective audit committees will likely result in adverse opinions based on the guidance in paragraph 126 of the Proposed Standard. The communication of the material weakness that resulted in the adverse opinion is useful information to the public. Furthermore, the auditor always has the option to withdraw from the engagement when the company and the audit committee do not respond appropriately to the situation.

7. Effective Date

We are fully committed to successfully implementing and performing the audits of internal control over financial reporting, and we understand the need to timely implement the new standard to meet the objectives of the Act. We also understand that the SEC has set the implementation date for Section 404 of the Act as the first fiscal year ending on or after June 15, 2004 for accelerated filers and for fiscal years ending on or after April 15, 2005 for non-accelerated filers and foreign companies. We recognize that the PCAOB is striving to meet that time frame under challenging circumstances.

However, this Proposed Standard is extremely significant due to both its complexity and its impact on companies and the auditors. While companies and auditors are preparing for implementation based on the knowledge and understanding to date, we are concerned that this Proposed Standard will not be finalized by the Board and approved by the SEC within a time frame that allows for successful implementation of the final standard for companies with June 2004 fiscal year ends. Indeed, companies with June 2004 fiscal year ends will likely be well into the third quarter of their fiscal year before this standard is finalized. Accordingly, it will be very difficult for companies and auditors to apply the provisions of the Proposed Standard to a fiscal year that is almost completed before the standard is final, especially considering that some

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2 SEC final rule, page 10.

internal controls over financial reporting may operate only on a quarterly basis. When the standard is finalized, companies and auditors will require a reasonable amount of time to understand the requirements, train staff, and implement changes. We urge the Board to work with the SEC and consider delaying the effective date for accelerated filers to fiscal years ending on or after September 15, 2004. This slight delay in the effective date contributes to a more successful implementation of the Proposed Standard and still results in the implementation in 2004 by the vast majority of public companies.

Additionally, if the Board decides to modify the auditor's interim responsibilities through this standard, we believe the effective date for any required changes to procedures performed for reviews of interim financial information should be effective starting the first quarter after the initial audit of internal control over financial reporting is performed.

8. Implementation Guidance

Because of the complexity and importance of properly implementing the Proposed Standard, we believe that a substantial amount of interpretation will be necessary as implementation occurs. Therefore, we believe that the Board should establish a formal process for responding to implementation questions from auditors and companies that will undoubtedly be forthcoming.

9. Impact of the Proposed Standard on Interim Standards

We are concerned with the impacts of the Proposed Standard on the Board's current interim standards, especially in relation to the procedures performed in connection with the financial statement audit, as well as for interim reviews of quarterly financial information. Throughout the Proposed Standard, the Board has incorporated changes that also have a significant impact on the Board's interim standards, creating inconsistencies between the Proposed Standard and the interim standards. However, this is not clearly evident. For instance, paragraph 138 of the Proposed Standard states that "the auditor should perform substantive procedures for all relevant assertions for all significant accounts and disclosures." However, the AICPA Statement on Auditing Standards that have been adopted by the Board as interim standards only require the auditor to perform substantive tests at the account balance or class of transactions level.[3] Another example relates to language in paragraph 141 of the Proposed Standard, which states that the auditor's substantive procedures must include "examining material adjustments made during the course of preparing the financial statements." This statement could be interpreted to mean that auditors are required to test every material journal entry made throughout the year and in the closing process, since they all relate to preparing the financial statements. Currently, auditors are not required to test every material journal entry during a financial statement audit.

It also is not clear how the Proposed Standard impacts the auditor's responsibilities with respect to interim financial information and the requirements under AICPA Statement on Auditing Standards No. 100, *Interim Financial Information*.

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3 AICPA Statements on Auditing Standards, *Internal Control in a Financial Statement Audit* (AU 119.81).

We suggest that each proposed auditing standard issued by the Board should clearly identify how the proposed changes will impact current standards, and what conforming changes will need to be made to existing interim standards. This will assist the auditor and the public in understanding the intentions of the Board and help to maintain consistency in the application of standards. An appendix with such changes might be a way to communicate the information.

10. Consideration of Small and Medium-Sized Companies

While the nature of controls at large companies may differ from the nature of controls at small and medium companies due to the size of the entity, management's responsibility with regard to assessment, evidence, and documentation should not be different. As indicated in paragraph E9 of the Proposed Standard, "the concept of control activities in a small company is the same as in a larger one."

However, Appendix E of the Proposed Standard does not articulate clearly that management's responsibilities remain the same regardless of the size of the entity and seems to imply that for small or medium-sized companies, management's assessment process, evidence, and documentation may differ from those for large companies. As such, Appendix E may allow interpretation by small and medium-sized entities that their assessment and documentation does not need to cover all significant accounts and all relevant assertions and may have the unintended consequence of the forcing the auditor to rely on inquiries of management regarding higher level monitoring practices rather than on reliable evidential matter.

Accordingly, we believe Appendix E should be modified to indicate that small and medium-sized companies are responsible for supporting the evaluation of internal control with sufficient evidence, including documentation (as indicated in paragraph 19 of the Proposed Standard) and that inadequate documentation of the design of controls and the absence of sufficient documented evidence to support management's assessment of the operating effectiveness of internal control over financial reporting are internal control deficiencies that may rise to the level of a significant deficiency or material weakness based on the auditor's judgment.

II. COMMENTS RELATED TO CERTAIN PARAGRAPHS

1. Specific Comments

Paragraph 14—Committee of Sponsoring Organizations Framework

The reference for more information about the Committee of Sponsoring Organizations (COSO) framework should be to the COSO document itself and not to AU 319.

Paragraph 15—Inherent Limitations in Internal Control Over Financial Reporting

In addition to the inherent limitation of internal control, we believe that the Proposed Standard should discuss the inherent limitations of management's assessment and the audit of internal control over financial reporting. We suggest the following language:

> The practitioner should plan and perform the engagement to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Absolute assurance is not attainable because of the nature of attestation evidence and the inherent limitations of internal control. Therefore, an examination of internal control conducted in accordance with attestation standards may not detect a material weakness. The subsequent discovery that a material weakness exists is not, in and of itself, evidence of (1) failure to obtain reasonable assurance; (2) inadequate planning, performance, or judgment; (3) the absence of due professional care; or (4) a failure to comply with attestation standards. Since the practitioner's opinion on internal control is based on the concept of obtaining reasonable assurance, the practitioner is not an insurer, and his or her report does not constitute a guarantee.

Paragraph 20—Management's Responsibilities and Disclaimer of Opinion

Paragraph 20 contains an unconditional requirement (under proposed Rule 3101) that the auditor disclaims an opinion if management has not fulfilled the four responsibilities enumerated in paragraph 19. We do not believe that a disclaimer is an appropriate form of report in all situations. For example, if management fails to support its evaluation with sufficient evidence but the auditor is otherwise able to conclude that effective internal control has *not* been maintained, we believe that a report expressing an adverse opinion is a more appropriate response. In situations in which fraud is detected, the auditor may be unwilling to continue with the engagement, depending on the magnitude. While we agree that a communication to management and the audit committee is warranted, issuing a report disclaiming an opinion does not seem adequate in such situations.

Paragraph 21—Materiality Considerations

The Board has proposed that the auditor should apply the concept of materiality at both (1) the financial-statement level in deciding whether a significant deficiency, or a combination thereof, represents a material weakness, and (2) the individual account-balance level in deciding whether a control deficiency, or combination thereof, represents a significant deficiency. We believe that management and the auditor have the responsibility to plan the evaluation to detect a material weakness, which is based on the threshold of a material misstatement, not at the individual-account-balance level. Accordingly we suggest that paragraph 21 of the Proposed Standard be clarified to clearly distinguish that materiality at the financial-statements level is relevant for the purpose of planning the scope of the audit of internal control, not materiality at the individual-account-balance level. We also suggest that the Board clarify materiality at the individual-account-balance level as it relates to the term "more than inconsequential," which is included in the definition of a significant deficiency of in paragraph 8.

Paragraphs 24-26—Fraud Considerations

We agree that both management and the auditor should consider the risk of fraud, as defined by existing auditing standards. However the requirement to evaluate "all controls specifically intended" to address the risks of fraud could be too broad or at least result in inconsistent application in practice. We do not believe it is possible for the auditor to determine which controls were intended by management to address the risks of fraud, nor can one distinguish between some controls to determine whether they are for just fraud or for fraud and error. We recommend that this be highlighted as a key consideration in the risk assessment component.

We believe the requirements set out in paragraphs 24-26, while laudable, do not provide adequate specificity against which the design and operating effectiveness of a company's fraud program and controls can be properly evaluated. Lacking such specificity, there will be wide variation in practice across companies and auditors. We recommend that the Board clarify what the auditor should consider in addition to the requirements in Statement of Auditing Standards No. 99. For example, the auditor must test the design and operating effectiveness of the company's antifraud programs and controls in response to the risks of fraud identified in the audit of the financial statements.

Paragraph 41—Evaluating Management's Assessment Process

We recommend inserting the word "all" in front of "relevant assertions."

Paragraph 43—Evaluating Management's Assessment Process

We recommend inserting the word "all" in front of "relevant assertions" in the first bullet point. Also it appears that bullet points four through six are a subset of bullet point one.

Paragraph 66—Assertions

The term "meaningful bearing" may confuse people in terms of deciding what a relevant assertion is and may result in inappropriate rationalization to exclude assertions that may be applicable but judged not to have an elevated risk associated with it. We believe the term should be replaced with "applicable."

Paragraph 69—Identifying Significant Processes

The concept of a significant process and major class of transactions are not defined, nor is it clear how one should go about identifying a significant process. Also the phrase "groups of accounts" is introduced here for the first time, but it is unclear as to what is a group of accounts and how it relates to a significant account. This step is important because the designation of a process as significant in paragraph 69 determines the scope of the auditor's walkthrough in paragraph 79. An example demonstrating the intent of these terms would be helpful.

Paragraphs 74-78—Identifying Controls to Test

We believe that the heading for this section of the Proposed Standard may be misleading as the section also addresses the linkage of the assertions and controls. Accordingly we suggest dividing this section into a section to describe the consideration of the linkage of the assertions, control objectives, risks and control activities and a section to provide guidance relating to identifying and planning the tests of controls. Recognizing that the audit process is seldom performed in a finite sequence, nonetheless it appears more logical to place the walkthrough before the identification of controls to test.

Additionally paragraph 75 notes that the auditor should "link individual controls with the significant accounts and assertions." Separately, in paragraph 78, the concept of control objectives is introduced but is it is not clear how this interrelates with paragraph 75. We suggest further clarification as to how the relevant assertions relate to control objectives and the intersection with the identification of risks and the related control activities.

Paragraph 84—Testing and Evaluating Design Effectiveness

Similar to the previous comment related to paragraph 74-78, there is no linkage of the control objectives to the relevant assertions mentioned, nor is there any mention of risks and the linkage to control objectives and control activities.

Paragraphs 94-99—Timing of Tests of Controls

More guidance on the period of time needed to conclude controls are effective at the "as-of" date is necessary, particularly for those control activities that are performed infrequently (e.g., controls performed monthly or quarterly). We also believe that it is important to provide more explicit guidance related to the term "sufficient period of time" in paragraph 99 as it relates to the auditor's responsibility and in paragraph 151 as it relates to management's responsibility. Unless the Board provides guidance on "sufficient period" and the appropriate time frame for obtaining sufficient evidence, there will be inconsistency in evaluating controls, particularly those implemented late in the year to correct significant deficiencies or material weaknesses.

Paragraphs 113-127—Forming an Opinion on the Effectiveness of Internal Control Over Financial Reporting

The first bullet point in paragraph 113 refers only to "the results of tests of controls." To avoid possible confusion, we recommend that the wording be expanded to read "the adequacy of the assessment performed by management and the results of the auditor's evaluation of the design and tests of operating effectiveness."

Paragraph 114 states that the auditor should review "all" review reports issued during the year by internal audit that address internal control over financial reporting and that such review should include reports issued by internal audit as a result of operational audits or specific reviews if those reports address controls related to internal control over financial reporting. We believe that in certain circumstances it may not be practical or reasonable for the auditor to review “all” reports. For example, a retailer with 1000 stores might perform 50 corporate audits and 400 store audits during a year. Additionally as part of the review of the internal audit function, the auditor should evaluate whether internal audit properly reports its findings to management and the audit committee and whether the company has in place an appropriate monitoring process to ensure that deficiencies identified are accumulated, monitored, and corrected on a timely basis. Accordingly if these processes are judged to be reliable, then we do not believe that the auditor should be required to read each internal audit report.

Paragraph 123 and 126—Examples of Significant Deficiencies and Strong Indicators of a Material Weakness

We believe it important to clarify that the listings contained in paragraphs 123 and 126 are not intended to be all-inclusive (e.g., if a type of deficiency is not listed, then it is not appropriate to presume that the deficiency is not a significant deficiency or material weakness). Furthermore, we believe clarification with respect to the reference in paragraph 126 to the identification of “fraud of any magnitude on the part of senior management” is necessary. The Board should clarify that the type of fraud referred to in paragraph 126 is consistent with the definition of fraud in Statement of Auditing Standards 99.

Additionally, the Board should clarify that the auditor is not required to assess a company’s regulatory compliance function. The Proposed Standard requires the auditor to consider “an ineffective regulatory compliance function” as a strong indicator of a material weakness. However, we do not believe it is the auditor’s responsibility to assess the effectiveness of a company’s regulatory compliance function. COSO, as well as the SEC, recognizes that compliance with laws and regulations is a separate area from internal control over financial reporting. As such, we believe that if the auditor becomes aware of events and circumstances leading him or her to believe company’s regulatory compliance function to be ineffective, then the auditor should assess the impact of such ineffectiveness on the auditor’s own conclusions about the effectiveness of internal control over financial reporting. However, the auditor should not be required to perform procedures to directly or indirectly assess the effectiveness of a company’s regulatory compliance.

Paragraph 128-129—Requirement for Management Representations

We recommend that representations from management also include representations related to the requirements under Section 302 of the Act, including that management has disclosed all significant deficiencies, not just material weaknesses in item d. In addition, similar to the construct for the financial statement audit, we suggest that the auditor be required to include as an appendix to the representations letter a listing of those deficiencies identified by the auditor, which had not been identified by management and, accordingly, include in the letter a representation that, in management’s opinion, the deficiencies identified by the auditor when considered with all other deficiencies do or do not rise to the level of a material weakness and that deficiencies identified by management and the auditors do not result in a material weakness for any of the three interim periods.

We also suggest that a representation be included in the letter that confirms that management has communicated the findings of their assessment, including all deficiencies identified by management, to the auditors, as required by paragraph 41.

If management refuses to provide a representation letter, the auditor should not have the option of issuing a report disclaiming an opinion; rather, no report should be issued and the auditor should withdraw from the engagement. The language used in paragraph 129 appears similar to that in the AICPA Attestation Standards; however, it omits one word that significantly alters the concept of reporting. The AICPA Attestation Standards provides for disclaiming an opinion or withdrawing from the engagement only when management fails to furnish *all* appropriate written representations. If management fails to provide any written representations, we believe the auditor is precluded from issuing a report. Further, the presumptively mandatory requirement in paragraph 128 should be changed to an unconditional obligation (e.g., "must") but specifically linked to the reporting ramifications in paragraph 129 of the Proposed Standard.

Paragraph 138-142—Effect of Tests of Control on Substantive Procedures

The requirement, in paragraph 139 of the Proposed Standard to test the controls over financial information used in substantive analytical procedures appears to prohibit the use of information obtained from an external source (e.g., external indices or ratios). Since substantial analytical procedures are often useful in detecting fraud, we suggest modifying the last sentence in paragraph 140 to read, "the use of analytics alone are generally not sufficient for detecting fraud." Furthermore, the last sentence in paragraph 139 makes reference to the significant risks of material misstatements. We believe the Board should clarify its definition of significant risks by providing a few examples of such risks. For instance, does the Board consider fraud or areas involving estimates and management judgment to represent significant risks of material misstatement?

In paragraph 141, the auditor is charged with the responsibility to examine material adjustments made during the course of preparing the financial statements. As discussed previously, we believe that this provision needs additional clarification. Additionally, we believe that similar requirements should be explicitly included in paragraph 41 relative to the Company's responsibility to identify and review material adjustments, in particular to address the risk of fraud related to management override.

We believe that any changes to the interim standards related to substantive procedures need to be highlighted in the Proposed Standard because they may not be obvious to the reader and may create inconsistencies with the Board's interim standards.

Paragraph 145-146—Documentation Requirements

The third bullet point in paragraph 145 of the Proposed Standard seems to require documentation of every possible risk, which is too far reaching. As stated previously, we believe that the Proposed Standard should more explicitly address the extent of consideration and documentation of risk in terms of both management (e.g., paragraph 41) and the auditor (e.g., paragraphs 74-78).

Paragraph 149—Management's Report

We strongly believe that the guidance provided that "other phrases" of an acceptable management conclusion may be appropriate is *not* appropriate for reporting under Section 404 of the Act and should be deleted.

Paragraph 152—Management's Report

The requirement in item e, "including those corrected during the period" is not required to be included in management's annual report as set forth in paragraph 148. This is a requirement of Section 302 of the Act and is addressed in paragraphs 183-189. Accordingly we believe this provision should be deleted.

Paragraph 161—Management's Report Inappropriate

Paragraph 161 states, "The auditor should modify his or her report to include, at a minimum, an explanatory paragraph describing the reasons for this conclusion" and fails to address whether the auditor should modify his or her opinion.

Paragraph 163 – Material Weakness

Paragraph 163 includes a list of elements required to be included in the auditor's report when a material weakness exists; however, the example in Appendix A does not appear to be consistent with these requirements. Additionally, the last bullet point states that the description of the material weakness should also address the requirements in paragraph 178; however, paragraph 178 requires the auditor to make a determination of whether the auditor's *opinion* on the financial statements was affected, but only requires language when it is *not* affected. We believe that the language illustrated in paragraph 178 should be included in all reports where there are material weaknesses, because it merely puts the reader on notice that the issued auditor's report has considered such matters and is appropriate. Accordingly, we recommend that a separate bullet point be added to paragraph 163. Further, we recommend that the Proposed Standard provide illustrative wording in paragraph 178 for a combined report rather than the current instructions to "revise this wording appropriately for use in a combined report."

The third bullet point requires the auditor to provide specific disclosure regarding any material weaknesses identified. We believe, that consistent with existing reporting models, such disclosure should be the responsibility of management in their report and that the auditor will provide supplemental disclosures only if management's disclosures were concluded to be deficient.

Paragraph 180—Subsequent Discovery of Information

Paragraph 180 "presumes" that if the financial statements are restated, the report on internal control should also be restated. This seems inconsistent with paragraph 126, which establishes a restatement as a "strong indicator," not a presumption. Further the wording "based on these considerations" appears irrelevant, as there are no considerations; it is a presumption.

Paragraphs 188-189—Auditor Evaluation Responsibilities

An inconsistency exists between paragraphs 188 and 189. Paragraph 189 requires the auditor to modify his or her report (a presumptively mandatory obligation), whereas paragraph 188 permits the auditor to resign from the engagement, in which case no report will be issued. An auditor concluding that withdrawal is necessary will not be able to comply with paragraph 189.

Appendices—General Comment

The Board has stated in its Statement of Authority that appendices to the Board's standards are an integral part of the auditing standards and carry the same authoritative weight as the body of the standard.[4] However, the status of appendices in AICPA Professional Standards, which the Board has adopted as interim standards, is different. AICPA Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards* (AU 150), which is incorporated into the Board's interim standards, includes appendices as interpretive publications that the auditor should be aware of and consider but are not required to apply. Under Statement of Auditing Standards 95 (AU 150.6), if the auditor does not apply the auditing guidance in an applicable interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such guidance. As such, while the auditor is responsible for following the interim standards themselves, the auditor has a lower level of responsibility for following the guidance in the appendices. Therefore, we believe the Board should clarify that the Board did not elevate the appendices as they exist today in the interim standards adopted by the Board to the same authoritative level as their related interim standards.

Appendix A—Illustrative Reports on Internal Control Over Financial Reporting

We have the following comments with respect to the illustrative report examples in Appendix A:

- We recommend that the definition paragraph be placed immediately preceding the inherent limitations paragraph. Such placement will significantly improve the readability of the reports, particularly when material weaknesses are reported or the report is a combined report on both the audit of the financial statements and the audit of internal control.

- The statement about management's responsibility is inconsistent. Some examples include a very narrow responsibility statement (e.g., that management is responsible for its assessment about the effectiveness), while other examples use a broader responsibility statement (e.g., that management is responsible for maintaining effective internal control). We believe that the latter should be used in all report examples.

- Paragraph 153e requires the report to include "a statement that the auditor's responsibility is to express an opinion on the *written* assessment based on his

[4] Proposed Standard, "Statement of Authority," Page A-2.

or her audit" [emphasis added]; however, the illustrated examples lack the word "written."

- We believe that the definition paragraph should refer to "accounting principles generally accepted in the [identify the country]". Additionally, the second sentence of the definition paragraph is misleading, as it implies that any internal control provides reasonable assurance, including those with material weaknesses. We believe such language should read as follows: "Effective internal control over financial reporting includes those policies and procedures. . . ."

- The inherent limitations paragraph does not address the unauthorized acquisition, use, or disposition of assets discussed in the definition paragraph. Accordingly, we believe that users of the report will inappropriately assume that there are no inherent limitations with respect to such matters.

- The auditor cannot opine on the management's assessment (process), which includes additional details that are not included in the company's report. We believe that the opinion paragraph should refer to "management's *written* assessment" [emphasis added] or "management's conclusion."

- We believe the following revisions should be made to the explanatory paragraph in Example A-2: (1) "will not be prevented or detected" should be added to the end of the first sentence, (2) the reference to management's assessment should be to "management's written assessment," and (3) the elements required by paragraph 163 should be described or illustrated. Further, the references in footnote 1 should be to management's *written* assessment.

- We noted the following additional inconsistencies in Example A-3: (1) "will not be prevented or detected" was omitted from the end of the definition of a material weakness in the explanatory paragraph, (2) the definition of a significant deficiency does not conform to the definition proposed by the Board in paragraph 8, (3) the reference to management's assertion in the introductory paragraph fails to recognize the material weakness referred to in the explanatory paragraph, and (4) footnote 1 provides an illustration as to how to modify the explanatory paragraph when the auditor detects additional material weaknesses; however, the opinion paragraph illustrated in the report appears to be the wrong opinion for such situation (i.e., the auditor should express an adverse opinion and not a qualified opinion).

- We believe that the introductory paragraph of Example A-4 should refer to the PCAOB's standards, given that there will be two different standards for auditing internal control (e.g., "We were engaged to audit, *in accordance with auditing and related professional practice standards established by the Public Company Accounting Oversight Board*, management's assessment. . . ."). Further, we believe that the opinion paragraph should read "we were unable to apply other procedures to satisfy ourselves as to *the effectiveness* of the company's internal control"; we believe the phrase "the effectiveness" was inadvertently omitted from the AICPA illustration for such situation.

- In Example A-6, we believe that the last sentence should refer to "opinion" singularly, consistent with reporting when the auditor reports on both the financial statements and financial statement schedules in a combined report.

Appendix B—Paragraphs B1-B16

While we agree with the framework set forth herein, it is not clear how this guidance intersects with the identification of significant accounts, significant processes and requirements to perform walkthroughs and tests of controls in the main body of the standard. We believe that, in multi-location situations, the locations or units will be selected first based on the guidance in Appendix B and then the guidance for identification of significant accounts, significant processes, and performing of walkthroughs, and tests will then be applied to each location, as applicable. An example of how the Board intends for this guidance to be applied is necessary; distinguishing between scenarios in which a common process/system is utilized for more than one location versus a scenario in which each location utilizes a different process/system.

We recommend that the Board provide guidance as to their view of "some" in paragraph B2 and "large portion" in paragraph B11. In addition, the terminology in Illustration B-1 should be conformed to the terminology used elsewhere in the Proposed Standard (e.g., "significant controls," "specific significant risks," and "specific risks").

Paragraph B10, which states that "if management does not have company-level controls" should be clarified to address whether the absence of common company-level controls is indicative of a deficiency. Additionally we suggest adding to the end of the first sentence "considering each of the 5 control components." We also suggest that additional guidance be added that although company-level controls may not exist at the overall company-level, they may exist, and therefore can be separately evaluated, at a level below the overall company-level (e.g., for one or more of the segments or line of businesses, etc).

We recommend that the Board clarify what is meant by the term "ordinarily" in paragraph B15 and "sufficient control" in footnote 1 to paragraph B16. Due to the lead times needed for coordination with third parties, it is important that companies and auditors clearly understand what is included in the public company's assessment and what is not. We believe that the scope for two companies with the same investees should not have different conclusions, just because one of them has access to evaluate the controls of the investee (e.g., via a contractual provision). Accordingly we support the determining factor as whether the Company has voting control, which is the lowest threshold at which companies are reasonably be expected to have access and the ability to evaluate the investee's controls.

Similar to the concept in paragraph B15, paragraph B16 should provide that for those entities not included in management's assessment, the Company and the auditor should include the controls over the reporting in accordance with generally accepted accounting principles of the company's portion of the income or loss, the investment balance, adjustments to the income or loss and investment balance, and related disclosures.

<u>Appendix B—Paragraphs B24-B39</u>

The criteria set forth in paragraph B26 list factors (the bullets in paragraph B26) for determining whether a service organization is considered part of the company's internal control over financial reporting. However there are no criteria for establishing what is a service organization, which is a very important decision for purposes of determining the scope of management's assertion. Additionally it is unclear how these factors relate to the similar items in AU324.03 of the Board's interim auditing standards.

Given the pervasiveness of the "extended enterprise" whereby outsourcing of processes and systems is commonplace, we suggest that clear guidance and examples of service organizations be provided including addressing the following types of relationships that are common today:

- Application systems
- Computing environments
- Transaction oriented processes (e.g., customer service, collections, manufacturing, warranty claims, coupons)
- Other back-office processes or support functions (e.g., legal, internal audit, taxes, environmental, actuarial, financial reporting).

The guidance does not establish any limitations of an auditor's use of service auditor reports. For example, if a company outsourced their entire accounting function including systems, processes, and financial reporting and the service organization makes an appropriate service auditor's report available, is it appropriate for management or the auditor to conclude on the effectiveness of the company's internal control solely on the basis of the service auditor's report? Our view is that guidance should be provided that establishes when it is appropriate to obtain and use a service auditor's report versus when it is not.

The second bullet point of paragraph B27 should refer to controls that are relevant to the company's internal control and not to controls that are relevant to management's assessment and the auditor's opinion. Additionally, paragraph B27 refers to AU Sec. 324.07, which describes procedures that auditors should perform, not management. The Board should separately provide guidance (e.g., paragraph 41 as to the procedures management should perform with respect to service organizations).

Paragraph B28 inappropriately refers to a service auditor performing a "review" of systems; however, the term "review" is reserved under the AICPA *Professional Standards* for services that are permitted when analytical procedures can be performed. As analytics cannot be applied to systems, we recommend that the word "review" be replaced with "apply procedures" or "examine."

The first sentence in paragraph B35 states, "If the auditor believes that he or she also *must* obtain evidence about the operating effectiveness of service center controls, one way an auditor can obtain such evidence is by obtaining a service auditor's report on controls placed in operation and tests of the operating effectiveness, as described in paragraph .245b of AU sec. 324." The use of the term “must” does not appear appropriate in this sentence given that this sentence implicitly requires auditor judgment (hence, the reference to “if the auditor believes”) and, therefore, it cannot be considered an unconditional obligation as the PCAOB has described the meaning of the term “must.”

The description of a report on operating effectiveness in paragraph B35 fails to recognize that such report also provides an opinion on the suitability of design of the controls.

Paragraphs B37-B38 discusses the procedures that the auditor should perform with respect to changes in controls at the service organization and presumes that management is aware of any and all changes. We believe that inquiries should include such matters as inquiring of management what they have done to ascertain whether there have been any changes in the service organization’s controls. Paragraph B37 also incorrectly categorizes errors identified in the service organization’s processing as a change in controls; this situation is better presented as an indicator that a change may have occurred. Accordingly, we expect the auditor to focus on how management investigated such matters, including the cause of the errors, and then evaluate the implications on management’s assessment and the auditor’s evidence.

For purposes of performing an audit of internal control over financial reporting, it is not clear whether the considerations of a service organization’s controls include only control activities or the other control components as they relate to the service organization as well. We also suggest the Proposed Standard provide guidance as to the impact on management’s and the auditor’s report, if management and the auditor are unable to obtain sufficient evidence as to controls at a service organization.

Appendix B—Paragraphs B40 and B41

We suggest that the Board clarify whether the examples included in the appendices, which are deemed to be authoritative, are also authoritative or only illustrative in terms of the nature, extent, or timing of the procedures. For example, has the Board established that a sample size of 25 items for a manual control and one item for a programmed control, in conjunction with inquiry and observation, is the minimum scope?

The following comments relate to Example B-1:

- Page A-91, first paragraph, item c, distinguishes between a programmed control and a detective control. We believe the distinction is a programmed control versus a manual control.

- Page A-93, item a, carried over from previous page states that “items that typically appear on the Daily Unapplied Cash Exception Report” suggests that the auditor’s focus is only on the “typical” items, not the unusual and infrequent.

- Page A-93, since the Daily Unapplied Cash Exception Report is a cumulative listing, we believe that it is necessary to observe it only once to update the tests to year-end, which could be done as a dual-purpose test for both the audit of internal control and the audit of the financial statements.

The following comments relate to Example B-2:

- Page A-94 it appears that the example, in the second paragraph, carves out other receivables from testing. It is not clear what the basis for that decision is based on the guidance provided in the standard.

- Page A-95, the first bullet point describes observing the control being performed. While observation is helpful for controls performed infrequently such as reconciliations, it is unlikely, within practical limits, that the auditor will be able to observe the employee performing the reconciliation.

- It is unclear why it is necessary for the auditor to scan the file of all reconciliations prepared during the year for the audit of internal control, since the auditor's report is "as of" a point of time, unless the intent is to portray this as a dual-purpose test for the benefit of the audit of the financial statements. Otherwise the auditor's responsibility is to determine whether the control has been operating for a sufficient period of time, the whole year seems to be too far reaching. We support testing the control for two months, once at interim and once at year-end.

The following comments relate to Example B-3:

- In Example B-3, it suggests that if "the auditor had encountered a control exception, the auditor would have tested an additional number of items." We suggest that testing more items is not necessarily the best response, particularly if the exception relates to a very large population. We suggest that a better response is to identify the root cause of the exception and then design tests to specifically search for additional exceptions.

- On page A-96, the first paragraph states, "the auditor expected no errors based on the results of company-level tests performed earlier." It is not clear how company-level controls in this example may impact the auditor's scope. Is this implying that there is a common process/system across multiple locations? Why does that impact the sample size? Further, the example goes on to say, "If the auditor had encountered a control exception, the auditor would have tested an additional number of items." It is unclear what control exception is being referred to—does this mean that if company-level controls were not adequate, the auditor should increase the sample size for testing cash disbursements?

The following comment relate to Example B-4:

- Page A-98 implies that the auditor has uncontrolled access to the company's systems in its description of the auditor's attempts to record the receipt of goods without a purchase order, to approve an invoice for payment, to process duplicate invoices, etc. We recommend that such procedures be described as being performed in the presence of appropriate individuals of the company. Had the auditor's attempts been successful, the auditor could be at risk for having altered the client's records; accordingly, such attempts should only be made in the client's presence so that the client can be immediately notified of any breach to their systems.

2. Pervasive Comments

<u>Use of Consistent Terminology</u>

We noted the following items, which we believe are examples of inconsistencies that should be addressed by the Board:

a. Management's assessment, management's written assessment and management's conclusion

Throughout the Proposed Standard these phrases are used. We believe that the phrase ***management's assessment*** encompasses various phases of management analyzing the design of its controls, testing and evaluating their operating effectiveness, forming its conclusion, documenting its work and preparing its written report. We also believe that the report that management prepares might be referred to as ***management's written assessment*** that contains, among other things, ***management's conclusion*** on the effectiveness of its internal control. The Proposed Standard, however, appears to use management's assessment interchangeably for both the process and the written report, resulting in confusion or factually inaccurate statements.

For example, management's assessment is much more than what is contained in the report of management. Paragraph 2 states that "The report of management is required to contain management's assessment . . . including a statement as to whether the company's internal control . . . is effective" while paragraph 5 states "the auditor evaluates the assessment performed by management." While only a description of the process (activities) can be included in the report, the auditor should be evaluating the process rather than the report. Accordingly, we recommend that the phrase "management's report" or "management's written assessment" be used when referring to the written communication of management required under Section 404.

Another inconsistency appears in paragraph 128b, which uses "evaluation" instead of "assessment" (i.e., the auditor should obtain written representations "stating that management has performed an evaluation of the effectiveness"). Evaluation is also used in paragraph 148.

b. Internal control over financial reporting, internal controls over financial reporting, controls, and internal controls

The Committee of Sponsoring Organizations of the Treadway Commission ("COSO") refers to internal control (singular) as a process; systems and controls make up the process. Individual controls or subsets of controls are referred to by COSO without the term "internal." The Proposed Standard will create confusion by using inconsistent terminology. For example, "internal controls [plural] over financial reporting" are used in paragraph 10-12 (although such paragraphs also contain the appropriate singular usage of "internal control over financial reporting"); "internal controls" is used in paragraph 11, 32, and 133.

c. Specific risks and significant risks

The term "specific risks" in used in paragraph B1, "significant risks" in paragraph 139, and "high risks" are referred to in the explanatory material and existing interim standards. We recommend consistently using "significant risk" throughout.

Compliance With Proposed Rule 3101

The Board's proposed Rule 3101 sets forth certain terms to describe the degree to which the Board expects auditors to comply with professional obligations included in the Board's Auditing and Related Professional Practice Standards. This Proposed Standard uses terminology that is inconsistent with the proposed Rule 3101 or describes procedures in a manner in which it is unclear as to the level of obligation. Paragraph 79 of the Proposed Standard discusses performing walkthroughs and states both "walkthroughs are required procedures" (a possible unconditional obligation) and "the auditor should perform a walkthrough for all of the company's significant processes" (a presumptively mandatory obligation). Other examples where it is unclear as to the auditor's obligation and that should be clarified include the following:

- Paragraph 85, "procedures the auditor performs to test and evaluate design effectiveness"
- Footnote 20 and paragraph 184, "need to evaluate"
- Paragraph 52, "should focus on combinations of controls"
- Paragraph 98, "should balance performing the tests"
- Paragraph 101, "should vary" the nature, timing and extent of tests
- Paragraph 180, "should presume that his or her report on the company's internal control over financial reporting . . . should be recalled"
- Paragraph 181, "the direction of AU sec. 711.10 to inquire of and obtain written representations . . . should be extended to matters that could have a material effect on management's assessment."

For presumptively mandatory obligations, the procedures "should inquire about and examine, for this subsequent period," various types of reports and "information about the effectiveness of the company's internal control over financial reporting obtained through other engagements" are far too vague.[5] Whom should the auditor inquire of—management, internal auditors, regulators? Is it some or all? And to what is "obtained through other engagements" making reference? It will be difficult for the auditor to comply with something that is not clear and subject to extensive interpretation.

[5] Proposed Standard, paragraph 171.

Although consulting the auditor's legal counsel about further actions to be taken when the auditor is addressing problematic situations is always advisable, we do not believe that the standard should create any presumptively mandatory obligations for the auditor to do so. We believe that documentation to demonstrate that the auditor considered consulting (as is currently be required under paragraph 176) and evaluated whether to consult (as is currently be required under paragraph 188) serves no useful purpose.

Paragraph 176 contains various other presumptively mandatory obligations that are again lacking in specificity, including such phrases as the auditor "should propose that management consult with some other party whose advice might be useful" and imply that the auditor should also discuss the matter with "those management has consulted." Further, we believe this paragraph should address whether the auditor should refrain from issuing a report.

We recommend that the Board analyze the use of the above phrases within the Proposed Standard and conform the terminology used so that it is clear which procedures the auditor is obligated to perform, presumptively required to perform, and required to consider.

References to Auditing Standards Issued by the AICPA

We question the extensive references to the AICPA *Professional Standards* throughout the Proposed Standard, as the PCAOB has only adopted the standards as in effect at a certain date. We recommend that references be made to the codification of the Board's interim standards, because the AICPA may subsequently amend its standards and, if so, the amended AICPA standards will differ from those adopted by the PCAOB.

III. RESPONSES TO SPECIFIC QUESTIONS

***Questions Regarding an Integrated Audit of the Financial Statements and Internal Control Over Financial Reporting*:**

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?***

Yes. It is 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.

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?***

Yes. Section 404(b) of the Act and the related SEC rule require that the attestation on management's assessment of internal control over financial reporting be performed by the registered public accounting firm that prepares or issues the audit report. We do not believe it is appropriate for an auditor to report on internal control over financial reporting of a public company unless the auditor performs the financial statement audit for the same period.

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?***

No. As stated above, the auditor that performs the audit of internal control over financial reporting should also be the auditor that performs the financial statement audit. In addition, we see no practical basis to define "work comparable to that required to complete the financial statement audit."

***Question Regarding the Costs and Benefits of Internal Control*:**

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 companies?***

No. Please refer to our comments in Section I, Overall Comments, Item 10, "Consideration of Small and Medium-Sized Entities."

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.***

Interim auditing standards as adopted by the PCAOB require that, through the first general standard, the audit be performed by a person or persons having adequate technical training and proficiency as an auditor, and, through the first standard of field work, assistants to be properly supervised. The decision to allocate tasks to assistants involved in an engagement is a professional judgment made by the auditor, after taking into account various factors including the level of experience of the staff involved and their knowledge of the company's operations. Supervision of assistants includes instructing assistants, keeping informed of significant problems encountered, and reviewing the work performed. Therefore, we do not believe it is necessary to specify the levels of competence and training necessary to perform certain auditing or attest procedures, as existing standards already require appropriate assignment and supervision of auditors.

Questions Regarding Evaluation of Management's Assessment:

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. Please refer to our comment under Section I, Overall Comments, Item 1, "Decision Mandating the Auditor to Audit the Underlying Controls as Well as Management's Assessment Process."

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

Yes. The auditor is responsible for determining whether management's documentation provides reasonable support for its assessment. Because the auditor is required to evaluate the sufficiency of management's process and documentation, we believe it is appropriate to provide the auditor with guidelines for performing such evaluation. However, the Board should provide more extensive and detailed criteria on this subject. Please refer to our comment under Section I, Overall Comments, Item 2.

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?***

Please refer to our specific comment in Section 1, Overall Comments, Item 3b, "Management's Responsibilities: Extent of Documentation."

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?***

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?

For questions 9 and 10, please refer to our specific comments in Section I, Overall Comments, Item 4b, "Issues Regarding the Scope of an Audit of Internal Control Over Financial Reporting: Performance of Walkthroughs."

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?

With regard to performing an audit of internal control over financial reporting, we believe it is necessary for management and the auditor to obtain sufficient evidence each year to form conclusions about the effectiveness of the design and operating effectiveness of internal control over financial reporting. In general, we do not believe it is appropriate to rely principally on audit evidence obtained in previous years in order to support a subsequent opinion. However, we do think the locations that are not individually significant could be tested by the auditor through the annual testing of company-level controls combined with testing at the location on a cyclical basis. This concept is consistent with the views expressed in Appendix B of the Proposed Standard. As such, we believe paragraph 101 of the Proposed Standard should be modified accordingly.

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?

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

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?

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)?

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?

For questions 12-16, please refer to our specific comments in Section I, Overall Comments, Item 4d, "Issues Regarding the Scope of an Audit of Internal Control Over Financial Reporting: The Auditor's Use of the Work Performed by Management and Others."

<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?

It is unclear to us whether the proposed definitions will provide for increased consistency. However, we do believe that the proposed definitions will result in more significant deficiencies and material weaknesses than the existing definitions. We believe the Board should clarify certain aspects of the proposed definitions.

First, the concept of immaterial is familiar to most users of financial statements; however, the concept of inconsequential is not as widely used or understood. Therefore, the Board should define inconsequential, clarify the relationship between inconsequential and immaterial, and explain how inconsequential relates to materiality at the account-balance level.

Second, the definitions of a significant deficiency and material weakness both refer to annual as well as interim financial statements. We agree that deficiencies identified in the audit of internal control should be evaluated for both the annual and interim impacts. However, some may read this to also imply that the auditor should plan and perform the annual audit of internal control, as well as evaluate any control deficiencies found, in the context of a materiality related to interim periods rather than the annual materiality. This appears to be inconsistent with the auditor's responsibilities with regard to management's certifications. Accordingly, we suggest the Board clarify that the auditor is not required to plan the audit of internal control to identify material weaknesses or significant deficiencies relating to interim periods; the annual or interim financial statements language applies only to the evaluation of deficiencies identified.

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?

In general, the examples provided in Appendix D of the Proposed Standard provide helpful guidance in the application of the definitions of various levels of control deficiencies to particular fact patterns. However, we believe the Board should clarify several issues.

First, while the Board specified that the examples in Appendix D are only for illustrative purposes, the Board also separately stated that appendices to the Board's standards are an "integral part of the standard and carry the same authoritative weight as the body of the standard."[6] It is unclear as to whether an auditor will be in violation of the Proposed Standard if he or she failed to arrive at the same conclusion as in the Board's examples, given similar fact

[6] Proposed Standard, "Statement of Authority."

patterns. Additionally, Appendix D uses the terminology "should" in several places; the word "should" signifies a presumptive obligation. Given the above, the Board should clarify the authoritative level of the illustrative examples included in Appendix D.

Second, the Board specified in paragraph 118 of the Proposed Standard that the significance of a deficiency in internal control over financial reporting does not depend on whether a misstatement actually has occurred however, the Board's examples D-1 and D-2 (Scenario B in both cases) includes within the fact patterns that a history of actual misstatements played a significant role in elevating a significant deficiency to the level of a material weakness in each case. To support the guidance in paragraph 118, we suggest that the fact patterns in one or more of the examples be revised to result in a material weakness when a misstatement has not occurred.

Third, the definition of internal control over financial reporting adopted by the SEC in its final rule contains considerations that expand beyond the reliability of financial reporting to include, among other considerations, the maintenance of records, as well as safeguards against unauthorized acquisition, use, and disposition of company assets. The Board should consider providing examples of control deficiencies in those areas, as well as the process and considerations for evaluating such deficiencies within the framework of the definitions of significant deficiency and material weakness proposed by the Board.

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

Because any one control deficiency could be a material weakness and a material weakness causes the auditor to issue an adverse opinion, the auditor must evaluate the significance of all internal control deficiencies identified as well as those internal control deficiencies identified by management. Otherwise, the auditor may fail to appropriately modify his or her report on management's assessment of the company's internal control over financial reporting. Furthermore, because an audit is conducted on a test basis, control deficiencies identified have actual as well as indicative significance. The actual significance of a control deficiency should be evaluated in terms of likelihood and magnitude, and its indicative significance should be evaluated to determine whether the existence of such deficiencies implies, points to, or raises the likelihood that other control deficiencies exist.

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. We believe it is appropriate to communicate all internal control deficiencies found in the course of the attestation engagement to management in writing. Communicating all deficiencies identified (and not just material weaknesses and significant deficiencies) in writing to management assists the company in improving its internal control over financial reporting. Management's propensity to correct all identified control deficiencies is also an indicator of the tone at the top and the control environment.

In terms of communicating with the audit committee, the Proposed Standard requires that the auditor communicate in writing all significant deficiencies and material weaknesses identified during the audit. We agree with this approach; however, we are not clear as to how this reconciles with the SEC's rule, *Strengthening the Commission's Requirements Regarding*

Auditor Independence, as it relates to required communications with the audit committee. The SEC's rule requires that the auditor provide the audit committee with copies of all material communications with management; therefore, it seems that the auditor will be required to provide the audit committee with a copy of the letter to management describing all deficiencies in internal control over financial reporting. The Board should reconcile the guidance in paragraph 190 with the requirements under the SEC's rule regarding audit committee communications.

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

In general, the Board should consider clarifying the meaning of the phrase "strong indicator" by providing examples or additional factors to consider for determining when a deficiency represents no more than a significant deficiency despite the existence of the strong indicator that a material weakness exists. For example, when might a restatement of a prior period or a material misstatement in the current period not be considered a material weakness? Further, the Board should clarify that the list of strong indicators of a material weakness is not meant to be an exhaustive list and that other issues that may not be on the list may be determined to be material weaknesses. With respect to individual strong indicators, we believe that a restatement of prior period financials should be a strong indicator that a material weakness existed *in the prior period*, but not necessarily in the current period.

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?

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

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?

For questions 22-24, please refer to our specific comments in Section I, Overall Comments, Item 6, "Evaluating the Effectiveness of the Audit Committee's Oversight."

<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?

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

For questions 25 and 26, please refer to our comments in Section 1, Item 5a, "Reporting: Requirement to Issue an Adverse Opinion in Certain Circumstances."

27. ***Do you agree with the position that when the auditor issues a nonstandard 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?***

Yes. We believe the auditor's opinion should speak directly to the effectiveness of the internal control over financial reporting in all situations. It can be confusing to users if the auditors issue a "clean" opinion on management's report that contained a material weakness. Indeed, the AICPA Statements on Standards for Attestation Engagements were modified by the Auditing Standards Board to require that the auditor's opinion speak directly to the effectiveness of internal control in order to address practices that developed among users who were not reading management's assertions but were only reading the auditor's report, and because initially the auditor's report only referred to management's assertion, users were not aware of the existence of material weaknesses in management's assertions. Accordingly, due to prior experience in practice, we believe it is important for the auditor to also disclose the material weakness by reporting directly on the effectiveness of the internal control rather than on management's process.

Questions Regarding Auditor Independence:

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

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

Strengthening the Commission's Requirements Regarding Auditor Independence, recently adopted by the SEC, modified rules with respect to auditor independence and set forth new limitations regarding the provision of nonaudit services by auditors. We do not believe further guidance is necessary.

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?***

We believe there is a general inconsistency in requiring the modification of the auditor's report on the effectiveness of internal control over financial reporting as of the company's fiscal year end (a point in time) based on procedures performed to determine changes to internal control over financial reporting during the fourth quarter (a time period.) The Board should consider separating the auditor's responsibilities with respect to quarterly certifications from the auditor's responsibilities with respect to the annual assertion by management. We suggest that the Board devise a reporting mechanism for the auditor to follow for any quarter in which the auditor believes material modifications should be made to management's quarterly certification.

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

The extent of work to be performed by the auditor in regard to quarterly disclosures about internal control is not clear in the Proposed Standard. Paragraph 186 requires the auditor to *determine* through "a combination of observation and inquiry" whether significant changes in internal control over financial reporting may introduce significant deficiencies or material weaknesses in the design of internal control over financial reporting.

Under current standards, procedures performed by auditors with regard to an interim review of financial information do not require the auditor to "determine" whether there are misstatements; rather, only to consider, based on the procedures performed, whether material modifications are necessary to the financial information as presented. The term "determine" implies that the auditor has a duty to identify all significant changes in internal control over financial reporting, which is likely to significantly increase the scope of the auditor's work. Furthermore, "observation" is a substantive procedure that is not currently part of the auditor's responsibility in the context of an interim review of financial information.

Further it is unclear what responsibility, if any, the auditor has with respect to management's conclusion at an interim period that a material weakness or significant deficiency previously identified and reported has been corrected. Does the auditor perform sufficient procedures to satisfy themselves that the deficiency has been corrected, or is inquiry and observation sufficient? Furthermore, what are the auditor's (and management's) responsibilities with respect to deficiencies that both arise and are corrected in the same period?

Additionally, some practical issues should be addressed including (1) some controls may not be observable either due to timing or because the controls are automated; it is not clear how the auditor should proceed with respect to those that can not be observed, and (2) it is not clear whether such procedures must be performed within the quarter as opposed to after the quarter-end when reviews of quarterly financial information typically occur.

We appreciate the opportunity to comment, and would be pleased to discuss these issues with you further. If you have any questions or would like to discuss these issues further, please contact Robert J. Kueppers at (203) 761-3579.

Very truly yours,

/s/ Deloitte & Touche LLP

cc: William J. McDonough, Chairman of the PCAOB
Kayla J. Gillan, Member
Daniel L. Goelzer, Member
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November 20, 2003

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
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RE: PCAOB Rulemaking Docket Matter No. 008

Ladies and Gentlemen:

Deluxe Corporation is a Fortune 1000 company and is the largest provider of checks in the United States, with 2002 revenues of $1.3 billion. Founded in 1915, Deluxe has been instrumental in shaping the payments industry and serving financial services companies. Deluxe recently received recognition from "Business Ethics Magazine" as one of the 20 best corporate citizens in America and a top ten ranking from Institutional Shareholder Services for our corporate governance practices. Gaining and maintaining the trust of consumers and the investing public is of paramount importance to us.

With that in mind, and our philosophy of adopting new regulatory changes related to financial reporting as soon as reasonably practical, we are taking on the new requirements of the Sarbanes-Oxley Act with our best efforts. We are quite far along with the work required by Section 404 of the Sarbanes-Oxley Act and have already completed the following as we strive to ensure our full compliance with the new requirements:

- Identified 54 accounts or processes we consider significant to our financial reporting.

- Identified and documented over 1,000 controls, 265 of which we consider key controls, for these 54 processes.

- Documented our entity level controls.

- Performed procedures, including a walkthrough of each process, to test the operating effectiveness of the 265 key controls.

- Engaged our independent auditor to perform attestation procedures for three processes. These procedures are approximately 50% complete and will be completed by mid-December.

To date, to complete the above, we have incurred over 3,000 internal hours, $250,000 for external consulting fees and $200,000 for independent auditor fees (which is 85% of our base independent auditor fees for 2003).

From this perspective, we have addressed the 31 questions on which the Board is seeking comment. The responses in bold are considered, by us, to be of higher importance.

Questions regarding an integrated audit of the financial statements and internal control over financial reporting:

Q1: 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?

A: Yes, the title is appropriate for the type of attestation being provided.

Q2: Should the auditor be prohibited from performing an audit of internal control over financial reporting without also performing an audit of the financial statements?

A: Yes, these engagements are inter-related and benefit from each other. It is not practical to complete one without the other, and we believe this will enhance the quality of the independent auditor's work in general.

Q3: 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?

A: No, this is not a practical solution. It would be difficult to replicate a financial statement audit and to do so would be cost prohibitive. Therefore, as we stated in response to question two, we believe that the same independent auditor should perform both the audit of the financial statements as well as the audit of internal control over financial reporting.

Question regarding the costs and benefits of internal control:

Q4: 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?

A: No, the proposed standard does not make this clear. We believe the standard should further explain the importance of the "tone at the top" (i.e., the control environment) as it relates to the impact of the testing and documentation requirements of the proposed standard.

Question regarding the audit of internal control over financial reporting:

Q5: 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.

A: No, this is not practical. The firms providing these services must be responsible to develop and maintain sufficient competent staff to carry out these engagements. In addition, guidance related to the competency of independent audit personnel is already covered in existing professional standards.

Questions regarding evaluation of management's assessment:

Q6: 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?

A: Yes, however, we have concerns over the limited level of reliance that the independent auditor can place on the work of management and internal auditors – specifically in the areas of IT general controls, the financial statement closing process and walkthroughs. Preliminary discussions with our independent auditor have led us to the conclusion that their current approach may cause them to complete an excessive amount of independent testing, thereby causing an excessive cost, both in terms of internal management time and their related fees. The ultimate responsibility to implement and maintain appropriate controls over financial reporting must reside with management. Therefore, we believe most of the independent auditor's assurance should come from assessing management's processes and compliance testwork related to internal controls.

We do accept that limited independent testing must be completed by the independent auditor. We respectfully submit, however, that this should be limited. We do not believe it appropriate or required that the principal evidence for the audit opinion be from the independent auditor's own work. The independent auditor should be allowed to exercise judgment and lean on their cumulative audit knowledge regarding the risks and control environment at each company to allow the independent testing to be reduced in companies with strong controls and with strong results during the initial year's assessment.

Q7: Is it appropriate that the Board has provided criteria that auditors should use to evaluate the adequacy of management's documentation?

A: Yes, it is appropriate that the Board provided documentation criteria. However, we believe this is an overall assessment that should be made by the independent auditor as the level and detail of documentation necessary may vary based on several factors, including the significance of the process in regard to the overall internal control structure. Therefore, we believe that the standard should allow the independent auditor to exercise professional judgment in evaluating the adequacy of the documentation.

Q8: 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?

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A: No, it should not automatically rise to the level of a significant deficiency or material weakness, as a lack of documentation alone will not lead to any misstatement of financial information. It is the lack of actual controls, not the documentation of the controls that could lead to misstatements. Therefore, we believe lack of documentation in a particular area should be evaluated by the independent auditor to determine its severity.

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

Q9:Are the objectives to be achieved by performing walkthroughs sufficient to require the performance of walkthroughs?

A: Yes, walkthroughs will help the independent auditor better understand the processes they are assessing. However, we believe walkthroughs should only be required for routine process with high transaction volumes. Non-routine processes that involve a significant amount of judgment do not lend themselves easily to walkthroughs. Therefore, we believe the standard should allow the independent auditor to exercise judgment about the appropriate procedures to be performed.

Q10: 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?

A: No, it is not appropriate to require that the walkthrough be performed by the independent auditor. We believe the standard should allow the independent auditor to exercise judgment in determining the level of reliance they place on the work of others. As such, the independent auditor should be able to utilize the walkthroughs prepared by management presuming they are properly documented and supported and were performed by competent and objective personnel.

If the requirement to have the independent auditor perform independent walkthroughs is maintained in the final standard, we would propose to our independent auditor that the walkthroughs be performed in conjunction with management testing at their direction. We would not want to duplicate walkthroughs for all significant control processes, as the cost of internal resources plus the incremental independent auditor fees would be far beyond the benefits attained. Requiring duplicative walkthroughs of all significant processes also could have the unintended consequences of encouraging companies to limit the number of processes they designate as "significant" in order to avoid excessive testing costs.

Question regarding testing operating effectiveness:

Q11: 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?

A: Yes, it is reasonable to expect the independent auditor to obtain evidence of the effectiveness of controls for all relevant assertions each year. However, it would also seem reasonable that if there have been no changes to the control processes since the previous year, the amount of testing could be reduced while still being able to obtain evidence on the control effectiveness. Therefore, we believe that the independent auditor should be able to utilize their cumulative audit knowledge and judgment in determining the appropriate level of testing.

Questions regarding using the work of management and others:

Q12: To what extent should the auditor be permitted or required to use the work of management and others?

A: We strongly disagree with the premise that the principal evidence for the audit opinion must come from the independent auditor's own work and believe that the standard places very little value on the work of management and internal auditors. The independent auditor should be required to use and place reliance on the work of management and others to the extent practical. Based on the current requirements, the company is already completing its own audit of the internal control over financial reporting. This effort should be extensively relied upon by the independent auditor. If this is not the case, management should forego its efforts, and this engagement should be executed like a traditional financial statement audit during which the principal evidence comes from the independent auditor's own work.

Q13: Are the three categories of controls and the extent to which the auditor may rely on the work of others appropriately defined?

A: The three categories of internal control, while intending to be helpful, have the effect of allowing very little reliance on the work of others. We believe that the standard should allow the independent auditor's discretion as to the amount of independent testing necessary in order for them to attest on the effectiveness of internal controls over financial reporting. Again, the current requirements will cost companies an excessive amount of time and money as management and the independent auditor will both be required to perform much of the same testing.

Q14: 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?

A: No, the standard does not give appropriate recognition to the work of internal auditors. More reliance should be able to be placed on the testing performed by internal auditors. The position of internal audit was created to be independent and objective from management, and current SEC and exchange rules also ensure this independence. Furthermore, the level of reliance the independent auditor can place on the work of internal auditors is already addressed in SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, for audits of financial statements and should be no different for audits of internal control over financial reporting. Therefore the work of internal auditors should be recognized as an

independent test of controls and allowed to be relied upon as such by the independent auditor.

Q15: 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)?

A: As we have indicated in our responses to previous questions, we do not believe a prescribed level of reperformance is practical. The amount of reperformance will vary based on many factors, including the competency and objectivity of the company personnel completing the work. Therefore, the amount of reperformance of the work of others should be left to the judgment of the independent auditor.

Q16: 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?

A: No, this is not an appropriate benchmark. Management is already going through the exercise of documenting and testing the company's controls. Therefore, the independent auditor should be able to heavily utilize this work in its attestation. If the independent auditor's work is the principal evidence, then management arguably should forego its efforts entirely and rely on that of its independent auditor.

Questions regarding evaluating the results:

Q17: 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?

A: Yes, the definitions of significant deficiency and material weakness will provide for increased consistency in the evaluation of deficiencies. We believe the definitions are appropriate. However, the actual determination of what rises to a significant deficiency or material weakness should still be left up to the judgment of the independent auditor.

Q18: 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?

A: Yes, the examples in Appendix D provide helpful guidance. We would suggest also providing an example of a significant deficiency and material weakness related to company level controls and information technology general controls. In addition, it would be helpful if the examples in Appendix D could be expanded to further explain situations where controls in place would keep a deficiency from elevating to the next level.

Q19: Is it necessary for the auditor to evaluate the severity of all identified internal control deficiencies?

A: Yes, in order for the independent auditor to reach a conclusion on the operating effectiveness of internal controls, they must evaluate the severity of the internal control deficiencies identified.

Q20: Is it appropriate to require the auditor to communicate all internal control deficiencies (not just material weaknesses and significant deficiencies) to management in writing?

A: No, the independent auditor should determine which deficiencies are communicated to management in writing. The independent auditor does not report all findings in a financial statement audit, especially findings of insignificant value. The same logic should be used for findings in audits of internal control over financial reporting.

Q21: Are the matters that the Board has classified as strong indicators that a material weakness in internal control exists appropriately classified as such?

A: Yes, the matters identified as strong indicators of a material weakness are appropriate. However, the determination of an actual material weakness should still be left up to the judgment of the independent auditor based on an evaluation of the item(s) in relation to the overall control environment.

Q22: 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?

A: No, this will create an inherent conflict of interest as the independent auditor is engaged by the audit committee. The purpose of maintaining the independent auditor relationship at the audit committee level is to allow the unencumbered assessment of management and the company's operations. To require the independent auditor to assess the audit committee would put the independent auditor in an awkward position. This position could cause the independent auditor to be unwilling to conclude that the audit committee is ineffective. In addition, the independent auditor may not have the level of expertise necessary to effectively evaluate an audit committee comprised of individuals with a much broader expertise than that held by the independent auditor.

Q23: Will auditors be able to effectively carry out their responsibility to evaluate the effectiveness of the audit committee's oversight?

A: No, as we stated in our response to question 22, we have misgivings about the independent auditor's ability to independently and objectively assess the audit committee's oversight. They may be hesitant to provide negative feedback as this could impact their relationship with the audit committee.

Q24: 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?

A: No, the independent auditor should not be required to withdraw from the engagement. If the company were required to hire a new independent auditor this would take resources away from improving the oversight.

Questions regarding forming an opinion and reporting:

Q25: 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?

A: Yes, a material weakness that has not been corrected prior to management's assessment date should result in an adverse opinion. The standard should be similar to a financial statement audit in that if there is a material misstatement of a company's financial statements, the independent auditor is not permitted to issue an unqualified opinion.

Q26: Are there circumstances where a qualified "except for" conclusion would be appropriate?

A: Yes, an "except for" conclusions may be appropriate under certain circumstances. These circumstances may include an acquisition completed within days of the end of a fiscal year.

Q27: 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?

A: The standard should require the opinion be consistently directed either at management's assessment of internal control over financial reporting or the internal control over financial reporting itself.

Questions regarding auditor independence:

Q28: Should the Board provide specific guidance on independence and internal control-related non-audit services in the context of this proposed standard?

A: Yes, the Board should provide specific guidance on independence and internal control-related non-audit services in the context of this proposed standard.

Q29: Are there any specific internal control-related non-audit services the auditor should be prohibited from providing to an audit client?

A: We agree with the current guidance in this area, specifically that which prohibits an independent auditor from performing any significant work that assists management in arriving at its assessment of the internal control over financial reporting.

<u>Questions regarding auditor's responsibilities with regard to management's certifications:</u>

Q30: Are the auditor's differing levels of responsibility as they relate to management's quarterly certifications versus the annual (fourth quarter) certification, appropriate?

A: Yes, the independent auditor's responsibility as it relates to management's quarterly certification should be consistent with the guidance provided in AU sec. 722, *Interim Financial Information.*

Q31: Is the scope of the auditor's responsibility for quarterly disclosures about the internal control over financial reporting appropriate?

A: Yes, the independent auditor's responsibility should correspond to the guidance provided in AU sec. 722, *Interim Financial Information.*

In summary, we believe that if the proposed standard is implemented in its current state, the costs will far outweigh the benefits of implementation. **<u>Initial discussions with our independent auditor indicate that our independent auditor fees could nearly triple next year solely as a result of the Sarbanes-Oxley internal control attestation requirements.</u>** To mitigate the excessive costs of implementation, we believe that there are two overriding factors in the proposed standard that should be modified.

1) The proposed standard is very prescriptive and does not allow the independent auditor to exercise sufficient judgment. As a result, the independent auditor must perform the same level of testing at companies with strong control structures as would be performed at those with weak control structures.
2) The proposed standard places very little value on the work of management and internal auditors. As a result, the independent auditor must reperform a significant amount of testing.

We respectfully request that the Board consider the additional financial burden being placed on companies when issuing the final standard.

Thank you very much for the opportunity to comment on the above-mentioned matter. We would be happy to respond to any questions you may have on our views or on our Sarbanes-Oxley Section 404 work. You can reach us at 651-483-7111.

Lawrence J. Mosner
Chairman and Chief Executive Officer

Douglas J. Treff
Senior Vice President and Chief Financial Officer

Katherine L. Miller
Vice President, Controller and Chief Accounting Officer

Via e-mail: comments@pcaobus.org

October 27, 2003

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

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

Dear Secretary:

Dixon Odom PLLC (Dixon Odom) appreciates the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB) proposed auditing standard relating to audits of internal control over financial reporting (the Proposed Standard). Dixon Odom is the largest CPA firm based in the Southeast with 450 employees and 16 offices in 6 states, auditing approximately 40 public companies.

Dixon Odom supports the issuance a new standard on auditing internal control over financial reporting that will meet the objectives of section 404 of the Sarbanes-Oxley Act of 2002. Regarding the Proposed Standard, we have the following comments.

Selected Questions
(numbers refer to question numbers in the Proposed Standard)

- 1. No. We would prefer that the term "audit" be used only to refer to an audit of financial statements to differentiate that level of service from other types of services. As indicated in the Proposed Standard, an audit of internal control over financial reporting is very different from an audit of the financial statements.
- 2. Yes. We believe these two engagements should be performed by the same auditor.
- 4. No. We would like to see additional information in this area. See "other comments" section below.
- 5. No. This would be unworkable and would create inconsistencies with financial statement audit requirements.
- 8. Yes. Documentation, especially at small entities, will vary greatly company to company. Inadequate documentation should not automatically result in a certain type of opinion.

- 10. No. If auditors can rely on work done by internal audit, management, and others in a financial statement audit and other aspects of an audit of internal control over financial reporting, it does not seem appropriate to require auditors to perform the walkthroughs themselves. It would be appropriate to require some level of subtesting of any work done by others in this area.
- 15. Yes. In order to rely on the work of others, auditors will have to perform some tests of their work. However, further mandating specific tests is not necessary, especially in connection with the overall requirement that the principal work be that of the auditor.
- 16. Yes.
- 17. See "other comments" below relating to these definitions.
- 22. No. See "other comments" below.
- 23. No. See "other comments" below.
- 24. No. Audit committee effectiveness is a very subjective area, and any guidance or requirements issued in this area should be broad rather than specific.
- 26. Yes. Many small entities could have appropriate controls, but there also could be segregation of duties issues that would best be addressed by an except for opinion.
- 28. Yes. The SEC recently issued an FAQ on auditor independence in addition to its recent rules on the topic. However, the rules and FAQ do not provide enough guidance in this area. Any additional guidance from the PCAOB would be helpful.

Other comments

- Although the term "internal control over financial reporting" is defined in the Proposed Standard, the term "control" is not. A definition or specific examples of controls would be useful. More specifically, it would be helpful to differentiate a control from a process. For example, the CFO may prepare a schedule calculating the valuation allowance for receivables. The preparation itself seems to be a process, not a control, as mere preparation by one individual would not prevent or detect a misstatement if errors were made. As another example, paragraph 41 includes as a control "controls over the selection and application of accounting policies that are in conformity with generally accepted accounting principles." Selecting and applying accounting policies also appears to be a process and not a control.

- Section 302 of the Sarbanes-Oxley Act of 2002 requires management to certify as to disclosure controls and procedures as well as internal control over financial reporting. The Section 302 certification, for example, addresses not only disclosures in the financial statements, but also disclosures in the quarterly or annual report filed with the SEC. Additionally, the FDICIA management reports (and related auditor attestation reports) filed by large banks may address financial reporting in accordance with generally accepted accounting principles and the Federal Financial Institutions Examination Council instructions for Consolidated Reports of Condition and Income (call report instructions). We therefore recommend that the Proposed Standard be revised to clearly specify that the engagement to audit internal control over financial reporting only applies as it relates to the audited financial statements and footnotes thereto, and not to other external financial reporting.

- The Proposed Standard introduces a new concept in discussing significant deficiencies in internal controls: a concept that a misstatement may be “more than inconsequential”. Presumptively, this definition of “more than inconsequential” would still be less than “material” since material misstatements would result in a material weakness in internal controls versus a significant deficiency. Currently, as auditors we must determine whether or not the financial statements are presented fairly in all material respects. Items that are material to the financial statements have been properly recorded, and any potential uncorrected misstatements are immaterial. The Proposed Standard now adds a third possibility that a misstatement could be less than material (i.e., immaterial) yet would still be highlighted because it is more than inconsequential. We believe the introduction of this new concept will only add to confusion regarding the relationship between the audit of the financial statements and the audit of internal control over financial reporting. We therefore recommend eliminating the concept of “more than inconsequential”.

- Management’s assertion as to internal control over financial reporting is to be made as of the end of year. This is analogous to an audit of the balance sheet, which is as of a point in time, versus a statement of operations, which covers a period of time. The Proposed Standard, however, introduces the concept in paragraphs 99 and 166 that if management changes controls during the year, there should be a sufficient time period that passes in order to determine that the new controls have been operating effectively. Otherwise, superseded controls would need to be evaluated. Given that management’s assertion is as of a point in time, we do not see the relevance of evaluating controls as of a date other than the period specified in management’s report when there has been a change in controls. For example, many acquisitions close at the end of a quarter or fiscal year. The controls resident at the acquired entity would be subject to management’s assertion as of the end of the year. However, controls prior to that point in time do not seem relevant. A similar analogy can be made for a year-end system conversion - the controls in effect prior to the conversion would not be covered by management’s end of year assertion as to effectiveness of controls.

- The Proposed Standard notes that controls must be tested by the auditor in order to evaluate operating effectiveness. Additional guidance as to appropriate sample sizes would be useful. Appendix B, Examples B-1 and B-3 indicate that a daily control is tested using a sample size of 25. Does the PCAOB intend that a sample size of 25 is considered the requirement for testing a daily control?

- Evaluation of the effectiveness of the audit committee is required by the Proposed Standard. For the reasons indicated in the following paragraph, we believe such a requirement is too far reaching and unworkable. In addition, auditors have recently been criticized for being too beholden to management, who prior to changes brought about by the Sarbanes-Oxley Act typically engaged the auditor and determined the auditor's fees. Many viewed this arrangement as containing an inherent conflict of interest. Under the current rules issued by the SEC, audit committees are now responsible for approving the auditors. Requiring auditors to separately evaluate the effectiveness of the audit committee will reintroduce the same conflict of interest scenario that the new SEC rules were meant, in part, to eliminate.

  Paragraph 57 indicates various factors that the auditor should evaluate in assessing audit committee effectiveness. Some of these factors, such as "how well the audit committee and management understand" audit committee responsibilities, are very subjective. As another example, the independence evaluation in paragraph 58 asks "does management pick 'friends'?" Asking auditors to evaluate audit committee members' understanding of responsibilities or whether or not those members are friends of management introduces a great amount of subjectivity to the audit of internal controls. Additionally, the Proposed Standard also requires evaluation of the audit committee's compliance with Section 301 of the Sarbanes-Oxley Act. AT 601, *Compliance Attestation*, of the AICPA's attestation standards currently provides guidance for a separate engagement to evaluate compliance with laws and regulations. Subsuming this sort of compliance evaluation into an audit of internal control over financial reporting conflicts with an already existing standard and overreaches the boundaries of an internal control engagement.

- Paragraph 79 of the Proposed Standard requires auditors to perform walkthroughs of all of a company's significant processes, indicating an auditor "should trace all types of transactions and events". Given that this procedure is a requirement (i.e., "should" perform), further guidance is needed on what the term "all types of transactions and events" means. If this language were to be broadly interpreted, theoretically every nonrecurring transaction in a significant process would need to be traced as each one would be different. Within recurring transactions, there could literally be hundreds of transaction types depending on amounts, counter parties, geography of counter parties, timing, sales channels, etc. Therefore, we recommend the language change to something like "In a walkthrough, the auditor traces a representative sample of transactions …" or "…significant categories of transactions…"

- Paragraph 157 notes that the auditor's report on internal control over financial reporting should be dated the same as the audit opinion on financial statements. However, financial statements of public companies can be audited without a corresponding audit of internal controls. By indicating that "the reports should be dated the same", there is an implication that a financial statement audit is not complete until the audit of internal control engagement is complete. If this is the goal of the PCAOB, the Proposed Standard should be revised to address this concept in more detail. Additionally, revisions to AICPA auditing standards adopted by the PCAOB as of April 16, 2003 may be needed. Otherwise, this language should be revised to indicate that the audit report on internal controls should be dated no earlier than the date of the audit report on the financial statements.

- The illustrative reports in Appendix A reference in the definition paragraph "generally accepted accounting principles". The audit report on financial statements, as illustrated in Example A-6, reference in the opinion paragraph "accounting principles generally accepted in the United States of America." We recommend conforming the language in the definition paragraph of the audit report on internal controls to the language used in the audit report on financial statements.

- Appendix E provides summary guidance for small and medium-sized companies. Dixon Odom's public company audit practice consists entirely of such companies. The Proposed Standard recognizes in paragraph E9 that the CFO's review of ratios and day-to-day involvement go "a long way in identifying and preventing material errors in the financial statements." We agree with the point of the statement, but the CFO's day-to-day involvement may not necessarily include "controls", depending on how that word is defined (see our first comment). Procedures and controls in a smaller entity are less formal, and documentation may be very limited. Therefore, we would like to see more guidance on documentation expectations for small entities as well as more guidance on testing controls that may not be documented.

  Additionally, CFO's in smaller entities typically rely heavily on their external auditor to ensure that the accounting principles used are appropriate and that proper disclosures are made. Reliance on the external auditor to provide substantial guidance in this area may not be a control per se, but it is reality. Audit committees of small entities rely similarly on outside auditors for advice on best practices for smaller entities. CFOs and audit committees of small entities depend heavily on external auditors and other professional advisors for expertise in many areas, including GAAP and SEC rules and regulations, since the resources of these companies are limited. Small entities take great comfort in the fact that their external accounting firm is reviewing and providing significant feedback on the financial statements and related disclosures, giving guidance over selection and application of accounting principles, and helping audit committees evaluate their role and the applicability of the myriad of regulations resulting from the Sarbanes-Oxley Act to small entities. For those reasons, we would like to see the Proposed Standard specifically address selection of accounting principles, preparation of financial statements and related note disclosures, and evaluating audit committee effectiveness for smaller entities, including the role of the accounting firm in these areas.

- As part of a financial statement audit under current GAAS, auditors may issue reports relating to internal controls such as a management letter, reportable conditions letter, or a no material weaknesses letter. These letters typically speak to the fact that the financial statement audit does not provide assurance on internal control. In connection with the issuance of the Proposed Standard, we would like to see the PCAOB provide guidance on the form and content of the aforementioned internal control letters (or audit byproduct letters), including whether or not they will be superseded by the Proposed Standard.

* * * * *

Again, we appreciate the opportunity to comment on the Proposed Standard. Thank you for considering our views. We would be glad to discuss our views with you in further detail.

Respectfully submitted,

S. Walter McNairy, Jr.
Director of SEC Services
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DOVER CORPORATION

280 Park Avenue
New York, NY 10017-1292

November 19, 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

Dear Sir,

We would like to thank Public Company Accounting Oversight Board ("Board") for the opportunity to comment on the proposed Auditing standard, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements" ("Standard"). The Dover Corporation ("Dover") would like to communicate its concerns with the proposed requirements regarding the independent auditor's evaluation of the effectiveness of the Audit Committee (Questions 22, 23 from PCAOP Release No.2003-017 dated October 7,2003).

Dover's primary concern is the inherent conflict of interest, from the external auditor's perspective, in evaluating the effectiveness of the Audit Committee. As required by the Security and Exchange Commission regulations, the Audit Committee is responsible for engaging, evaluating and compensating the external audit firm (the "auditors"). In light of this fact, it would seem that the ability of the auditors to independently evaluate the effectiveness of the Audit Committee is impaired and therefore of limited value. In essence, the proposed requirement transfers the conflict of interest issue from one between the auditors and management, to one between the auditors and the Audit Committee. In addition, the specific requirements of the evaluation as defined in Paragraphs 57 and 58 of the proposed Standard, including independence in relation to management and the evaluation of Audit Committee nomination and selection process, are relatively subjective in nature. This subjectivity further exacerbates the potential for conflicts of interest.

The AICPA Code of Professional Conduct identifies the occurrence of a conflict of interest when "a member performs a professional service for a client or employer and the member or his or her firm has a relationship with another person, entity, product, or service that could, in the member's professional judgment, be viewed by the client, employer, or other appropriate parties as impairing the objectivity". Certainly the financial relationship between these two parties – the Audit Committee and the auditors - has the potential to impair objectivity that limits both the effectiveness of the proposed evaluation procedures and the public's reliance on the auditor's evaluation.

In summary, the evaluation of the effectiveness of the Audit Committee should be considered outside the scope of the Auditor's attestation on Management's Assessment of the Company's internal controls. While an evaluation of the Audit Committee's role and effectiveness should be considered in the overall assessment of internal controls, it should not be a specific requirement of the audit procedures defined by the Standard. Alternatively, if the evaluation component is retained in the Standard it should be modified to provide specific, objective guidelines for the evaluation of the Audit Committee.

We respectfully request that the Board reconsider the requirements related to the auditor's evaluation of the Audit Committee and modify the Standard accordingly.

Michael B. Stubbs
Chairman, Audit Committee
Dover Corporation

Robert G. Kuhbach
Vice President, Finance & Chief
Financial Officer

Raymond T. McKay, Jr.
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CERTIFIED PUBLIC ACCOUNTANT • CERTIFIED FRAUD EXAMINER

November 19, 2003

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

Re: <u>PCAOB Rulemaking Docket Matter No. 008</u>

I am pleased to have this opportunity to comment on the PCAOB's Proposed Auditing Standard, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements." This proposed standard is exceptionally well written and comprehensive, and, in my opinion, will significantly enhance investor protection by improving the credibility and reliability of financial reporting by public companies. I, therefore, wholeheartedly endorse this much needed and well balanced standard and recommend its early adoption by the PCAOB. I also wish to commend the authors of the proposed standard for their significant efforts in producing such an excellent document.

The remainder of this letter constitutes my detailed comments and suggestions relative to certain provisions of the proposed standard, and I respectfully request that the PCAOB consider them in finalizing the standard. Such comments and suggestions refer to the specific paragraph numbers in the text of the proposed standard.

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1. **Paragraphs 32-35 Independence**

Paragraph 32 states that: "The applicable basic principles of independence are that, to remain independent, the auditor must not function in the role of management and must not audit his or her own work." I recommend that the proposed standard also include a statement that the auditor must not act as an advocate of the client and not enter into improper relationships with the client that would result in a conflict of interests. This could result, for example, in a situation where the auditor designs and implements systems and controls that have a significant impact on the audit client's internal controls and financial reporting.

I am concerned about an auditor providing "internal control services" (paragraph 33) to his or her audit client when the auditor must also render an opinion regarding the client's internal control. Unless the internal control services are insignificant, it is difficult to imagine that the auditor is not compromising the appearance of his or her independence and that the auditor is not running the risk of auditing his or her own work. Moreover, having the audit committee pre-approve the internal control-related services does not mitigate or cure the two problems referred to above. Unless the internal control services performed by the auditor are insignificant, it would be better to prohibit such internal control services in order to avoid problems and abuses regarding this potential conflict.

2. **Paragraphs 79-83 Performing Walkthroughs**

I agree that walkthroughs should be a required procedure and that they should be performed directly by the auditor. However, in practice, I have seen repeated failures regarding two aspects of walkthroughs. The first is that the scope of the walkthroughs is often woefully inadequate. I have seen auditors trace only one transaction through systems for key accounting cycles. This is especially risky where there may be different types of transactions in a particular accounting cycle. The second aspect is that inexperienced, new staff personnel typically perform walkthroughs despite that they may not have the audit experience and training to even understand all of the processes involved in a complex accounting cycle. Accordingly, I recommend that the PCAOB consider these two issues and incorporate language in the proposed standard that requires walkthroughs to be performed by appropriately experienced staff and clarify that the scope be sufficient to provide assurance that the auditor has covered all types of transactions in a particular accounting cycle. I further recommend that language be incorporated that specifically requires the tracing of more than one transaction through a particular accounting cycle system.

3. **Paragraphs 103-110 Use of the Work of Management and Others**

In paragraph 109, the proposed standard states that 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. I recommend that an additional statement be made following such sentence emphasizing that the higher the risk of misstatement relative to a particular account or system, the greater the requirement for the auditor to perform the testing himself or herself.

In paragraph 103, consideration should be given to adding an additional factor in deciding whether to use the work of management and others, as follows: "The potential for management override of particular controls and the overall system of internal control." Consideration should also be given to adding this same point in paragraph 104.

4. Paragraphs 116-127 Evaluating Deficiencies in Internal Control Over Financial Reporting

Paragraph 126 states that one of the strong indicators that a material weakness in internal control over financial reporting exists involves significant deficiencies that have been communicated to management and the audit committee which remain uncorrected "after some reasonable period of time." I suggest that consideration be given to providing a guideline or a definition as to the meaning of "some reasonable period of time" in order to avoid confusion and inconsistency in the application of this provision of the proposed standard.

5. Paragraphs 128-130 Requirement for Written Representations

Paragraph 128 states that in an audit of internal control over financial reporting, the auditor should obtain written representations from management. I recommend that an additional sentence be added which states that, while such representations constitute part of the evidence the auditor obtains, client representations alone are insufficient evidence upon which to base the auditor's opinion and are not a substitute for obtaining other sufficient competent audit evidence.

6. Appendix E Special Internal Control Over Financial Reporting Considerations for Small and Medium-Sized Companies

Paragraph E3 states that the integrity of senior management often plays a critical role in establishing a strong control environment in a small company. Moreover, throughout Appendix E, statements are made to the effect that the interaction of senior management in small companies can provide an effective control environment and, thus, play an important role in maintaining effective internal controls in such companies. While such statements are certainly true, there can also be an additional risk factor in small companies caused by the dominance of one or a few senior management individuals which, in turn, can cause a significantly increased risk of management override and circumvention of controls and systems. In practice, I have seen as many problems with senior management override of controls and systems as I have seen enhanced internal control by senior management. Accordingly, I recommend that a description be included in Appendix E which explains that dominance by senior management can often cause greater potential override of internal control systems in small companies.

Thank you for this opportunity to express my views and offer recommendations relative to the proposed standard on internal control. Should you have any questions or need additional information, please do not hesitate to contact me.

Yours very truly,

Charles R. Drott

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:
Proposed Auditing Standard—An Audit of Internal Control
Over Financial Reporting

Dear Sir/Madam:

The Eastman Kodak Company ("Kodak" or the "Company") is pleased to comment on the Public Company Accounting Oversight Board's ("Board") proposed *Auditing Standard—An Audit of Internal Control Over Financial Reporting* ("Proposal").

Kodak is a global company engaged primarily in the developing, manufacturing and marketing of traditional and digital imaging products, services and solutions for consumers, professionals, healthcare providers, the entertainment industry and other commercial customers.

Kodak is committed to creating and maintaining a strong system of corporate governance. We believe that good corporate governance is based on a system of people, principles, processes and procedures. We also believe that an internal control structure over financial reporting is an important and fundamental cornerstone of that system.

While we support the Board's efforts to create a standard that would integrate the audit of financial statements with the audit of internal control over financial reporting, we disagree with many aspects of the Proposal in its current form. Certain of the requirements of the Proposal will create duplication of effort and inefficiencies in the operations of organizations. We believe that the Board has attempted to create requirements around internal control over financial reporting to obtain a level of assurance about the reliability of a company's financial statements for which the related costs of obtaining such level of assurance exceed the benefits.

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Questions regarding using the work of management and others:

We do not support the Proposal's three categories of controls and the limitations on the extent to which the external auditor may use the work of others for each of these categories. For example, the Proposal indicates that an auditor may not rely on the work of others with respect to testing of controls in the control environment, including controls around a company's information technology systems and controls specifically intended to prevent or detect fraud. These are two areas where an internal audit function would perform extensive testing and, therefore, the external auditor should leverage that work. We believe that the external auditor should be able to use its professional judgment to determine whether or not to rely on the work of the internal audit function of a company. As is the case with many public companies, Kodak's internal audit function is an important aspect of the control structure. It is comprised of competent, professional individuals who follow a strict set of policies and procedures while conducting its extensive work under an annual global plan, which is reviewed with and approved by senior management and the Company's audit committee.

To place the types of formal limitations on the extent to which the external auditor may use the work of others, including the internal audit function, will create significant duplication of effort, a significant increase in the cost of audit services and an unnecessary burden on various individuals throughout the organization, which in turn will create inefficiencies in the operations of organizations. The cost of achieving the level of assurance that a company's controls over financial reporting are working as designed by having the external auditor reperform (as a result of its inability to use the work of others) much of the same testing that the internal audit department performs, far exceeds the benefits. At a time when many foreign companies are not subject to the same rules as public registrants in the U.S., these inefficiencies and increased cost only serve to further restrict a company's ability to be competitive.

The reliance that the external auditor can place on the work of management and others, including internal audit, should be based on the external auditor's professional judgment and aligned with the reliance that the external auditor is currently able to place on internal audit to reduce the auditor's work in the performance of the annual audit of a company's financial statements.

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

We agree that the objectives to be achieved by performing walkthroughs, which are to understand how internal control over financial reporting is designed and whether the related controls are operating as they were designed, are sufficient to require the performance of walkthroughs. However, consistent with our response to the questions regarding using the work of management and others, we do not believe that the external auditor should be precluded from using the work performed by management and others, including internal audit, to satisfy the requirement to perform walkthroughs. As previously discussed, Kodak has a formal internal audit function that reports to senior management and the audit committee, which performs extensive work, including walkthroughs, within the Company's various businesses and functional areas to ensure that the Company's internal controls are operating as designed. Therefore, to preclude the external auditor from leveraging the work performed by the internal audit department would create significant duplication of effort, a significant increase in the cost of audit services and an unnecessary burden on various individuals throughout the organization, which in turn will create inefficiencies in the operations of organizations.

We believe the extent to which the external auditor uses the work of management and others, including internal audit, to perform walkthroughs, should be based on the auditor's professional judgment, taking into account the nature and documentation of the work performed by internal audit and the specific risks associated with a company's various significant processes.

Furthermore, we believe that requiring annual walkthroughs for all significant processes (defined as processes over each major class of transaction affecting significant accounts or groups of accounts) and location is excessive, especially in light of the proposal to preclude the external auditor from using the work of management and others, including internal audit. The requirement for external auditors to trace all types of transactions and events, both recurring and unusual, from origination until they are reflected in the company's financial reports for all significant processes each year, when much of this work has already been performed or could be incorporated into the scope of the work performed by internal audit, is unwarranted.

We believe that the external auditor should be able to apply professional judgment in determining which significant processes require annual walkthroughs and the extent to which it can leverage the work of management and others to achieve the objectives of such tests.

Questions regarding evaluating results:

We do support the Proposal's requirement that the external auditor evaluate the severity of all identified internal control deficiencies, and we do believe that the auditor should communicate all internal control deficiencies to management in writing, regardless of whether or not they have been deemed significant deficiencies or material weaknesses. The reason for this is that internal control deficiencies that are not currently deemed to be significant deficiencies or material weaknesses could evolve into a significant deficiency or material weakness as the related facts and circumstances change. However, we do not believe that the proposed definitions provide for increased consistency in the evaluation of deficiencies. Further, we strongly believe that the Proposal creates too low of a threshold for what constitutes a significant deficiency and material weakness.

The Proposal states, "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. [Emphasis added.] In our opinion, this definition will not drive consistency due to the fact that it still requires the use of professional judgment in its interpretation, based on the specific facts and circumstances. Additionally, we believe that the use of "remote likelihood" and "more than inconsequential" in the definition is confusing and will only serve to make the evaluation and designation of internal control deficiencies more difficult. Further, because the Proposal's definition of what constitutes a significant deficiency and material weakness establishes a threshold that is set too low, we believe that this will create an environment where audit committees will be presented with too much information that is not meaningful or substantive and, over time, may serve to make the audit committees insensitive to those deficiencies that are in fact significant or that should qualify as a material weakness.

We believe the definitions for significant deficiency and material weakness should be simplified using widely-understood terms. Additionally, we recommend that, if the Board continues with its proposed definition and concepts, that it considers the costs and operational impact to organizations, their external auditors and audit committees of setting too low of a threshold for internal control deficiencies to meet the criteria for a significant deficiency or material weakness. Even the Board acknowledges that internal controls should be designed and operated to provide reasonable assurance (high), but not absolute assurance, about the reliability of a company's financial reporting and its process for preparing and fairly presenting financial statements in accordance with accounting principles generally accepted in the U.S.

We do not support the provisions that require the external auditor to evaluate the effectiveness of the audit committee and, in fact, believe that that the provisions create a direct conflict with Section 301 of the Sarbanes-Oxley Act of 2002. Section 301 makes the audit committee directly responsible for the appointment, compensation, and oversight of the work of the external auditor, approving certain non-audit services, and resolving disagreements between the auditor and management regarding financial reporting. In our opinion, Section 301 requires the audit committee to assess the effectiveness of the external auditors. The Proposal requires that the external auditor evaluate the effectiveness of the audit committee, a group of individuals who are responsible for the oversight of the auditor's work. We question the operationality and effectiveness of this "circular" requirement and believe that it creates a conflict of interest and an independence issue for the auditor.

A committee appointed by the New York Stock Exchange (the "Committee") recently made a set of recommendations about improved corporate governance, stating with respect to the role of the audit committee:

> "...the [audit] committee stands at the crucial intersection of management, independent auditors, internal auditors, and the board of directors."

We support the Committee's description of the role of the audit committee. We are concerned that the Proposal's requirement for the auditor to assess the effectiveness of the audit committee could impact the audit committee's ability to perform its important role in improving corporate governance. Consequently, we recommend that the Board drop from its proposed standard any requirement that the auditor evaluate the effectiveness of the audit committee.

In summary, we do not support the Proposal in its current form. We believe that the requirements of the Proposal are overly burdensome and its implementation and ongoing compliance will introduce significant costs and inefficiencies to organizations. We believe that adoption of the Proposal has the potential to place U.S. public companies at a disadvantage with its foreign competitors who are not required to comply with such rules and regulations. We urge the Board to consider various provisions particularly in the area of the external auditor's use of the work performed by management and others, including internal audit. We believe that a substantial amount of savings can be achieved, in terms of both cost and operational efficiencies, if external auditors can use and rely upon the work performed by well-established internal audit functions, while also meeting the spirit and objectives of the Proposal. We further suggest that the Board work with professional organizations such as the American Institute of Public Accountants and the Financial Executive International (FEI) to understand the "true" cost of implementation of its Proposal. The Committee on Corporate Reporting of FEI estimates that audit fees likely will increase by 30-50% if the Proposal is adopted without change. That increase seems overly onerous for any company to have to bear, especially those trying to compete in a global environment.

We appreciate the opportunity to comment on the Proposal. If you have any questions regarding our comments or would like further information, please contact Gisele Dion, Director of Accounting Research, Policies, and Procedures at 585-724-6246.

Sincerely,

Robert H. Brust

United States of America

Public Company Accounting Oversight Board

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 PCAOB Rulemaking Docket Matter No. 8**

Comments of the Edison Electric Institute

I. Introduction and Executive Summary

The Edison Electric Institute (EEI) appreciates the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB's") Proposed Rulemaking[1] on Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements.

EEI is the association of United States shareholder-owned electric companies, and international affiliates and industry associates worldwide. In 2001, our U.S. members served more than 90 percent of the ultimate customers in the shareholder-owned segment of the industry, and nearly 70 percent of all electric utility ultimate customers in the nation. They generated almost 70 percent of the electricity generated by U.S. electric utilities.

While EEI is supportive of much of the PCAOB's proposal, we have several concerns as outlined in these comments. The approach taken in our comments is to respond to questions posed by the PCAOB in the proposed auditing standard. In several instances, we have commented on two questions

[1] Public Company Accounting Oversight Board, Proposed Rulemaking; Release No. 2003-017, Docket Matter No. 008, October 7, 2003.

together with one response. EEI commends the PCAOB for the thorough and detailed proposal submitted for public comment and is generally in agreement with many of the proposed rules. However, EEI is concerned that the proposed auditing standard represents a rules-based approach rather than providing a standards/principles-based document for consideration. Additionally, EEI believes there are several areas where the proposed auditing standard could be improved including:

- Extent and form of documentation required by management;
- The restrictive nature of certain key terms and definitions, such as “significant deficiency;”
- Reliance on the work of management and internal auditors by the independent auditors;
- Real or perceived conflicts of interest in evaluating the effectiveness of the Audit Committee; and
- The inability to issue a qualified “except for” opinion.

As a result, EEI would like to comment on the questions addressing these and other issues as put forth by the PCAOB in its proposal.

II. The PCAOB’s Proposed Standard

a. Is it appropriate that the Board has provided criteria that auditors should use to evaluate the adequacy of management’s documentation? (Question 7)

Paragraph 43 of the proposed auditing standard sets forth guidelines auditors should use to evaluate management’s documentation of internal controls over financial reporting. EEI believes that the guidelines are overly prescriptive.

As properly noted in paragraph 44, management's documentation may take many forms and can include a variety of information. Management utilizes many different methods to document its internal controls; examples include policy and procedure manuals, flowcharts, etc. Management may also utilize formal and informal training courses to instruct employees on how to use systems or process transactions. The methods used to document controls are as varied as the controls themselves.

Paragraph 43 specifies, among other things, that management's documentation should include:

- The design of controls over relevant assertions related to significant accounts and disclosures;
- Information about how transactions are initiated, recorded, processed and reported;
- Enough information about the flow of transactions to identify where material misstatements due to error or fraud could occur.

Based on this guidance, existing internal control documentation in many companies may have to be substantially revised to meet the proposed requirements. Generally, documentation of internal control policies and procedures discusses what "must be done right" as compared to what "could go wrong." Documentation often does not include or refer to the five financial statement assertions. Management views controls in its policies and procedures as actions taken to achieve some general or specific objective. It is rare to encounter a description of a control and its relationship to the relevant financial statement assertions. The documentation linking a control to an assertion and to a significant account is also a rare occurrence.

To accomplish what the proposed guidelines require, would require that each financial reporting control be linked to its relevant assertions as well as to a significant account. While this linkage could be accomplished, the effort to do so would require a significant amount of work and resources because, in a large company, there are likely several thousand controls over financial reporting.

Alternatively, on an overall basis, management could determine that the relevant assertions for each financial statement line item are adequately covered by controls. If the financial statement line items are linked to specific assertions and each line item is mapped to various financial statement cycles and controls, this documentation would serve as the link between financial statement assertions and the underlying controls supporting them. This approach would require a more reasonable effort to comply with the standard and would accomplish the same objective.

Further, the documentation requirement will necessitate a very large up-front effort and may be impractical to implement in a timely and meaningful manner for certain events, such as acquisitions of non-public companies, new system implementations and significant changes to business procedures. The impact is magnified for those events that occur at or near end. The focus for these types of events has always been on controls that provide reasonable assurance that financial statements are reliable.

b. 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? (Question 8)

EEI believes that the guidance in paragraph 46 is adequate. The auditor should evaluate the documentation deficiency, which should take into consideration the significance of the deficiency. All facts and circumstances should be considered along with any mitigating controls the company may utilize to monitor information in the absence of clear and available documentation. Therefore, EEI believes that it is not appropriate to automatically raise inadequate documentation issues to the level of a significant deficiency or material weakness.

c. 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? (Question 10)

EEI believes that it is not necessary to require that the walkthrough be performed solely by the auditor. Rather, the auditor should be permitted to use procedures performed by management. If management, internal auditors or others have sufficiently documented the company’s processes to provide the same information that would be captured via a walkthrough, then the auditor should only be required to review this documentation and apply professional judgment as to whether it is necessary to perform any independent walkthroughs.

The procedures performed by the auditor should be intended to be an audit of management's process to assess the design and operating effectiveness of controls. EEI believes that procedures, as required by the proposed auditing standard, are intended to "validate" work rather than repeat or replicate work previously performed by management of the company.

d. 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 assertions? (Question 11)

Paragraph 74 states that "the auditor should obtain evidence about the effectiveness of controls (either by performing tests of controls himself or herself or by using the work of others) for all relevant assertions related to all significant accounts and disclosures in the financial statements." Paragraph 101 further states that "the auditor should vary from year to year the nature, timing, and extent of testing of controls to introduce unpredictability into the testing and respond to changes in circumstances."

EEI believes the auditor should be allowed to use some degree of the audit evidence obtained in the previous years to support the nature and extent of his or her testing for the current year's opinion on management's assessment. In a subsequent year, the auditor should be allowed to incorporate the results of his or her testing in a previous year into the planning for the current year audit.

A requirement that the auditor perform its own testing of effectiveness of all controls over significant accounts and disclosures each year will eliminate some level of judgment in the auditor's planning process and make it more difficult to introduce variability in the auditor's plan from year-to-year, as is discussed in paragraph 101 of the PCAOB's proposed rules. Additionally, paragraph 101 seems to indicate that not all controls would be tested independently by the auditor each year. This requirement has the potential to focus a significant amount of testing in the same areas each year rather than appropriately identifying areas which should require more attention, such as those that are affected by other changes in the organization (*e.g.,* employee turnover, increases in volume/nature of transactions, etc.).

EEI believes the draft auditing standard should allow the auditor to incorporate the results of its testing in previous years, along with the review of both management's and internal audit's (when applicable) testing of internal controls in the current year, in supporting his or her opinion on the effectiveness of internal control over financial reporting. Further, EEI believes the current guidance included in the draft auditing standard will result in an independent controls assessment by the auditor which, in essence, duplicates management's assessment rather than resulting in an audit to express an opinion on management's assessment of the effectiveness of the company's internal control over financial reporting as required by paragraph 4 of the proposed rules.

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

EEI believes that auditors should be permitted to use the work performed by management, internal auditors or by other professionals on behalf of management, based on the auditor's assessment of management's control environment and the competence and objectivity of the people performing the work. For most companies, substantial time and effort has been and will be devoted to documentation and testing of controls by management and internal audit.

The proposed restrictions on the auditor's use of the work of others for evaluating controls regarding (a) the control environment; (b) the period-end financial reporting process; (c) those with a pervasive effect on the financial statements; (d) those over significant non-routine and nonsystematic transactions; and (e) those over significant accounts are too restrictive. Tests of controls by other than external auditors can be documented to the extent that the auditor can review the documentation and then use professional judgment as to the extent of re-testing. As discussed throughout this letter, EEI does not believe that the final auditing standard should impose absolute requirements upon the auditor to replicate and re-perform significant amounts of work previously performed by management. Rather, the requirements should provide the auditor sufficient latitude to exercise professional judgment regarding the nature and extent of testing necessary to audit management's assessment of the design and operating effectiveness of internal controls over financial reporting. Such latitude is permitted in conducting the audit of financial statements and is also appropriate for an audit of internal controls over the preparation of those financial statements.

f. 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? (Question 14)

The discussion in paragraph 108 regarding using the work of internal auditors provides an appropriate level of recognition to the necessity of evaluating the competence and objectivity of internal auditors. The emphasis that reliance can be greater when those functions adhere to the Institute of Internal Auditor's Association's (IIA) Standards is appropriate.

However, EEI believes that the provisions of paragraphs 103 – 106 inappropriately fail to distinguish internal audit from the broad category of operating management and are likely to restrict the level of reliance that can be placed on the work of internal auditors, even those who exhibit the highest levels of independence, competence and objectivity.

In companies with a strong internal audit function, extensive work will be done by internal audit to evaluate and test (a) processes to prevent and detect fraud; (b) controls over the period-end financial reporting process; and (c) controls that have a pervasive effect on the financial statements, such as information technology general and application controls.

In most cases, the work of internal audit may be even more robust than that performed by the external auditors. Prohibiting reliance on the work of internal auditors in these areas will result in a failure to take advantage of significant on-point evaluations of internal control effectiveness.

Additionally, independent auditors currently evaluate and place some reliance on the work of internal auditors in order to perform an audit of a company's financial statements. Establishing a standard for auditing internal controls over the preparation of financial statements that is more restrictive than the current standards governing audits of financial statements is inconsistent and would confuse financial statement users. EEI agrees that the reliance on the work of internal auditors related to controls discussed in paragraphs 104 and 105 should be more limited than reliance on controls over routine processing as discussed in paragraph 106. However, the independent auditor should be given the flexibility to rely on the work of internal auditors in all areas deemed appropriate in the exercise of his or her professional judgment.

The proposed standard's limitation on using the work of internal audit is also internally inconsistent with other aspects of its provisions. Specifically, paragraph 126 of the proposed standard indicates that an ineffective internal audit function should be a "strong indicator that a material weakness in internal control over financial reporting exists." As a result, most companies will determine that an effective internal audit function is necessary, and it seems appropriate that the independent auditor should be able to rely on the internal auditor's work to a significant degree.

Finally, EEI believes that those provisions of the proposed standard are at variance with existing Statement on Auditing Standards (SAS) No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*. SAS 65 permits the auditor to request direct assistance from the internal auditors. Direct assistance relates to work the auditor specifically requests the internal auditors to perform to complete some aspect of the auditor's work. It typically includes assisting the auditor in gaining an understanding of internal control, performing tests of controls and other substantive audit procedures. Internal auditors work under the direct supervision of the auditor and apply auditing procedures as prescribed by the auditor. The work is supervised and reviewed by the auditor. This direct assistance is used as a means to leverage the skills and knowledge of the resident internal audit function and reduce the total cost of the audit.

Internal auditors historically have fulfilled an independent role in assisting the external auditors in connection with an audit of financial statements. Considering the implementation of the proposed internal control standard is expected to require substantial effort and significant cost. EEI believes the final standard should recognize explicitly that the internal auditors are permitted to assist the auditor in such examinations consistent with the direct assistance provisions in SAS 65. The position in the proposed standard is not consistent with the role internal auditors play in connection with an audit of financial statements.

g. Is the flexibility in determining the extent of re-performance of the work of others appropriate, or should the auditor be specifically required to re-perform a certain level of work (for example, re-perform tests of all significant accounts or re-perform every test performed by others that the auditor intends to use)? (Question 15)

Paragraph 103 states that “the auditor should evaluate whether to use the work performed by management and others.” However, paragraph 104 lists four major areas where the auditor should not use the results of testing performed by others and paragraph 105 lists two major areas where the auditor’s use of work performed by others is limited. The net result is to require the auditor to re-perform the majority of all tests of controls. Therefore, EEI believes that the final standard should provide greater flexibility to the independent auditors in determining the extent of re-performance work required.

h. 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? (Question 16)

The key to this limitation is centered on the interpretation of the auditor's "own work." This term could be interpreted to mean that the auditor's documented review of the work of others would be sufficient; or, "own work" could be interpreted to mean that the auditor must either perform or re-perform all tests of controls. EEI believes the former would be the best interpretation.

i. Will the definitions in the proposed standard of significant deficiency and material weakness provide for increased consistency in the evaluation of deficiencies? How can the definitions be improved? (Question 17)

EEI has serious concerns regarding the definition of "significant deficiency" and "material weakness" centered on the use of the terms "more than a remote likelihood" and "more than inconsequential in amount." These phrases are likely to be interpreted to go beyond the "reasonable assurance" intent of COSO and the Securities & Exchange Commission ("SEC").

The COSO framework indicated the following regarding what internal controls cannot do: "An internal control system, no matter how well conceived and operated, can provide only reasonable – not absolute – assurance to management and the board regarding achievement of an entity's objectives. The likelihood of achievement is affected by the limitations inherent in all internal control systems. These include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake." EEI believes that controls designed and operated to meet the standards in COSO's "Internal Control – Integrated Framework" will not be adequate given the definitions of significant deficiency and material weakness in the proposed standard. Specifically, the phrases "more than a remote likelihood" and "more than inconsequential in amount" are too restrictive for most internal controls over financial reporting.

EEI believes it is critical that clear definitions are established - considering standards already in place such as those provided in the COSO framework – that describes the terms (a) deficiency; (b) significant deficiency; and (c) material weakness.

The definitions used in the final standard are critical to an investor's understanding of a company's internal controls over financial reporting and the related audit opinion. For example, with non-routine and non-systematic transactions, an evaluation of "likelihood" is not appropriate because, in this instance, the auditor must be concerned with the qualitative nature of the deficiency. One "remote" non-standard journal entry can materially affect the financial statements. While the chance of this event occurring may be "remote," when it does occur, the consequences can be significant. Therefore, for non-recurring and non-standard transactions, EEI believes the evaluation of the significance of a control deficiency must take into account the qualitative aspects of the deficiency as opposed to its likelihood of occurrence.

EEI believes the term “more than inconsequential in amount” establishes a very low threshold of significance. Although it is not defined explicitly in the proposed standard, EEI interprets this term to mean an amount that is substantially less than that which would be considered “immaterial” to the financial statements. Consequently, a deficiency that could misstate the financial statements by an immaterial amount would still be considered significant in quantitative terms. As a result, EEI believes that using this definition will elevate, unnecessarily, many control deficiencies to the “significant” category and result in many unnecessary discussions between auditors, management and the Audit Committee on the resulting categorizations. Using overly restrictive criteria has the potential to take the focus away from those areas that are truly material to the company.

j. 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? (Question 22) Will auditors be able to effectively carry out their responsibility to evaluate the effectiveness of the audit committee's oversight? (Question 23)

EEI does not believe that it is appropriate to have the auditors evaluate the effectiveness of the Audit Committee's oversight of a company's external financial reporting and internal control over financial reporting.

This requirement presents a conflict of interest for the auditors due to the Audit Committee's responsibilities as defined in Section 301 of the Act which requires the Audit Committee to be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by the company for the purpose of preparing or issuing an audit report or related work; the registered public accounting firm shall report directly to the Audit Committee.

Paragraph 57 of the proposed auditing standard requires the auditor to evaluate the Audit Committee's level of involvement and interaction with the auditors, including the Audit Committee's role in the appointment, retention and compensation of the auditor. EEI believes this conflict of interest will inhibit the auditor's ability to successfully evaluate the effectiveness of the Audit Committee's oversight.

Additionally, the auditor is currently required to evaluate the role of the Audit Committee as part of understanding the control environment to appropriately plan the financial statement audit in accordance with SAS No. 55, *Internal Control in a Financial Statement Audit*. This evaluation is appropriate because it is for the auditor's own use in planning its work, rather than for reporting to the body responsible for engaging its services. EEI believes that the proposed rules should not impose a separate and more prescriptive requirement of an auditor's evaluation of the Audit Committee than is already established by the American Institute of Certified Public Accountant's generally accepted auditing standards.

k. 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? (Question 25)Are there circumstances where a qualified "except for" conclusion would be appropriate? (Question 26)

EEI does not believe it is appropriate that the existence of one material weakness would require management and the auditor to express an adverse conclusion about the effectiveness of the company's internal control over financial reporting.

By only allowing one type of audit opinion - an adverse audit opinion – there is no ability to differentiate the impact and/or severity of material weaknesses among various companies. As an example, a company that has one isolated material weakness, the effects of which are limited and can be compensated for by substantive testing, will have the same opinion as a company that has one material weakness that is pervasive in its effect over financial reporting. EEI believes that such differentiation is critical to a financial statement user's understanding of a company's internal control over financial reporting and is necessary to provide a meaningful conclusion on the reliability and effectiveness of internal controls.

Given the proposed standard's definition of a material weakness in internal control and the broad spectrum of potential impacts of a material weakness in internal control, significant judgment is required for management's conclusion on the effectiveness of internal control and the independent audit opinion to be meaningful. EEI believes there are many circumstances where a qualified "except for" opinion would more accurately communicate relevant information about the existence and effectiveness of the entity's internal controls and would be more useful for investors and other users of the financial statements.

Investors and other users of financial statements are familiar with the types of audit opinions expressed for a financial statement audit. Most investors and other users of financial statements have a clear understanding of the potential ramifications of an adverse opinion and also understand the circumstances where a qualified "except for" opinion may be required. Consistent with that understanding, financial statement users view an adverse audit opinion as one where the effects of deviations from generally accepted accounting principles ("GAAP") are so material and pervasive that they overshadow the fairness of the financial statements. Users also understand that a qualified “except for” opinion is issued when the financial statements are presented in accordance with GAAP, except for the matters to which the qualification relates.

With this understanding, the absolute requirement that a single material weakness requires management to conclude that internal controls over financial reporting are not effective and for the auditor to express an adverse opinion about the effectiveness of the company’s internal control over financial reporting, without provision for exercising judgment, has the potential to have significant negative implications in financial markets; it would create confusion and would be misleading to investors and other financial statement users and would potentially reduce investor confidence.

As mentioned previously, considerable professional judgment is required to effectively evaluate the significance of a material weakness and its impact on the opinion to be issued. By requiring management to conclude that controls are not effective and for the auditor to issue an adverse opinion for one material weakness, regardless of other circumstances surrounding the weakness, does not provide the ability to adequately communicate to the investing pubic the actual impact of the weakness to the company. EEI believes that the proposed rule should be modified to eliminate this absolute requirement to issue an adverse opinion on the audit of internal control over financial reporting and to provide examples of circumstances in which management and the auditor should evaluate the impact of a material weakness. Some considerations which may result in a qualified "except for" opinion rather than an adverse opinion should include:

- A material control weakness that is isolated to one system or area;
- The significance and impact on the financial statements;
- The type of material control weakness and compensating controls;
- The nature of assets at risk;
- The presence of other control weaknesses;
- The extent, nature and timing of recent changes in the company's accounting process or procedures, business practices, or regulatory requirements;
- Past experience with the entity.

An adverse opinion should be limited to those situations where control weaknesses are material and pervasive, where little or no reliance may be placed on the internal control structure, or where there is fraud committed by management or employees with a significant role in internal control over financial reporting.

In addition, under the proposed rules, it is possible for a company to obtain a clean audit opinion on the financial statements, yet obtain an adverse audit opinion on its internal controls over financial reporting. This will certainly confuse investors as they believe that internal controls are designed to provide reasonable assurance regarding the reliability of financial statements.

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

EEI believes that the three broad principles as set forth by the SEC on auditor independence provide adequate, complete guidance regarding auditor independence.[2] These principles state that the auditor cannot function in the role of management, cannot audit his or her own work, and cannot serve as an advocate for management. These principles, when combined with the SEC's rules governing Audit Committee pre-approval of all services to be provided by the independent auditor constitute appropriate guidance in this area and no additional guidance is necessary.

III. Conclusion

EEI understands and acknowledges that, in order to restore broad investor confidence, most public companies will be required to make new investments to comply with many provisions of the Act, particularly to strengthen and report on internal control in accordance with section 404. EEI supports the spirit of the requirements of the Act and generally concurs with the provisions of the proposed rule on auditing internal controls. However, EEI also believes that the final standard should not impose any more requirements than are necessary in order to achieve the

[2] Securities & Exchange Commission, Regulation SX Rule 2-01.

objectives of the Act. Thus, many of the comments in this letter focus on ensuring that the final standard does not mandate duplicative procedures that add little value and will place excessive burdens on companies working to comply with the Act. In particular, EEI recognizes the value of independent review and testing by the independent auditors; however, excessive duplication of efforts already performed by management and internal auditors will not enhance the value of the attestation process.

EEI appreciates the opportunity to provide comments on this proposal and respectfully requests that the PCAOB consider our concerns and recommendations.

Sincerely,

David K. Owens
Executive Vice President – Business Operations Group

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

Ladies and Gentlemen:

E. I. du Pont de Nemours and Company appreciates the opportunity to comment on the proposed auditing standard, *An Audit Of Internal Control Over Financial Reporting in Conjunction with an Audit of Financial Statements*. DuPont fully accepts its responsibility to implement and execute effective controls over financial reporting. However, we believe the proposed standard should be modified to take a more balanced, yet equally effective, approach in obtaining this objective.

Rather than address each of the 31 questions in the proposed auditing standard, our response covers matters of particular concern to us. In addition, we are in agreement with the Committee on Corporate Reporting of the Financial Executives International's letter dated November 20, 2003 which covers general concerns and responses to all questions.

DuPont fully supports the need for management's assessment of the effectiveness of the company's internal control over financial reporting as well as the independent accountants' attestation of such assessment. In our review of the proposed auditing standard the following matters were of special importance to us:

Cost

We believe that without permitting significantly greater reliance by the external auditor on the work of management and that performed by a company's internal audit staff, the cost of complying with this standard will become unnecessarily excessive. The same considerations for the external auditor's use of "reasonable professional judgment" in determining effectiveness of internal controls for smaller companies should extend to all companies.

Principle Evidence

We do not support this requirement without a better definition of "principle evidence," and believe that this aspect of the standard has the potential to create confusion and misunderstanding. If this is interpreted by the audit profession to mean more than 50 percent of the evidence must be directly obtained by them, an interpretation which we believe is certainly possible, the cost of the engagement will increase to a level that far outweighs the benefit. In addition, this could cause companies like ours, with large well-qualified internal audit organizations, to reduce internal audit staff due to both the level of duplicative testing and the high overall cost. Therefore, we view the need for a clear definition of "principal evidence" to be very important.

We also believe that the auditor should rely on multiple sources of evidence in arriving at their opinion. These sources would include the results of management self-assessments, the scope and results of internal audit test work and finally the external auditor's own testing. The use of a "principle evidence" standard for the auditor should not discount these first two essential steps in a well-developed management evaluation process. To do so would result in duplicate testing and excessive audit fees.

Appropriate Reliance on Internal Audit and Management

The DuPont Company would clearly prefer that the standard limit the auditor's evaluation to a test of management's assessment process, supported by a testing of the design of controls and not to a test of the controls themselves. The standard as currently written has the potential to create a significant amount of duplicative testing and cost. At a minimum the auditor should be permitted to rely more heavily on the test work of management, including significantly broader reliance on the work of internal audit. The auditor also should be permitted to consider company core values and "tone at the top" and their associated impact on the control environment.

Reliance on Prior Audit Work

In many organizations controls supporting key business processes are identical from year to year. In such circumstances, the auditor should be able to utilize cumulative audit knowledge and judgment in determining the appropriate level of testing. In a well-controlled environment, an update or review to ensure no material change should be adequate.

Walkthroughs

We accept that walkthroughs are an important audit technique but we believe the standard as written requires too broad an application of this technique. Walkthroughs should be optional, primarily focused on routine processes and be limited to control activities. A standard definition of what constitutes a walkthrough should also be provided. Paragraphs 79 and 80 provide a standard for walkthroughs that would be very difficult for the auditor to execute in large multinational companies like ours and accordingly, be very costly.

External Auditors Evaluation of Audit Committee's Effectiveness

Given the recent and appropriate emphasis on eliminating consulting arrangements between companies and external auditors that could provide the opportunity for and/or appearance of a conflict of interest, we recommend that this requirement be dropped. In the best of circumstances the proposed evaluation process will be difficult and awkward to execute given the audit committee's responsibilities for appointing and approving fees for independent accountants. Under New York Stock Exchange *Corporate Governance Rules*, audit committees will be required to conduct an annual performance evaluation. We believe this process will be both objective and adequate to ensure effective oversight by audit committees.

DuPont appreciates the opportunity to provide the Board with its perspective on the approach to implement this important new audit standard.

Sincerely,

Daniel B. Smith
Vice President & Controller
E. I. du Pont de Nemours and Company
1007 Market Street
Wilmington, DE 19898

www.lilly.com

Eli Lilly and Company
Lilly Corporate Center
Indianapolis, IN 46285
U.S.A.

Phone 317 276 2000

November 21, 2003

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

Re: Proposed Auditing Standard - An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements, *PCAOB Rulemaking Docket Matter No. 008*

Ladies and Gentlemen:

Eli Lilly and Company appreciates the opportunity to respond to the Proposed Auditing Standard - *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements.* Reliable and trustworthy financial statements are part of our corporate brand and we at Eli Lilly and Company take internal controls related to financial statement reporting and disclosure very seriously and believe that good controls need to be emphasized and set by the tone-at-the-top of an organization.

We support and appreciate the Public Company Accounting Oversight Board's (the "Board") efforts to provide guidance on the role of external auditor when auditing internal controls as required by Section 404 of the Sarbanes-Oxley Act (the "Act").

We have specific concerns over the proposed standard that, if not addressed, will increase the amount of work carried out by business operations and will result in costs that are disproportional to the benefits gained. Specific responses to certain questions of the proposed standard on which we have concerns are included in the Appendix. A summary of our response is as follows:

- We believe that the proposed standard presents a balanced approach to the audit of internal controls over financial reporting. However, we believe that the proposed standard does not allow the auditors to use their judgment on the amount of testing to be carried out. Auditors should be allowed to determine the strength of the controls structure and then use their judgment on the amount of testing that needs to be carried out. The amount of testing on routine transactions for an organization with a strong controls environment should be less than one with a weaker controls environment.

The Act requires the auditors to attest on the management's assessment of the effectiveness of internal control, and therefore requiring the auditors to obtain the same amount of direct evidence for a strong controls organization as for a weak controls organization seems to add cost but does not add value.

- We also believe that the proposed standard does not allow the auditors to rely enough on the work (both walkthrough procedures and testing) carried out by a competent, independent internal audit department. The auditor should evaluate the internal audit department as prescribed by SAS 65, and use their judgment as to if they can rely on the work carried out by the internal audit department. In not relying on work of the internal auditors, there is a risk that the external auditor will be performing work that is both duplicitous and non-value added. In addition, there will be an increase in audit fees that would not seem justifiable for corporations with independent, competent internal audit departments. We believe if the proposed standard is left unchanged, it could lead to a decreased recognition and reliance on the internal audit function when it comes to audit of the financial statements. We believe that the proposed standard should allow management to assist the auditors in the performance of the walkthrough tests by providing the required documentation and evidence that the auditor requires. Alternately the proposed standard should allow an independent, objective and competent internal audit department to carry out the walkthrough tests while the auditors observe, re-perform and/or review the results.
- We also do not believe that it is appropriate for auditors to be required to evaluate the effectiveness of the audit committee. We believe that an inherent conflict of interest exists for an auditor to evaluate the audit committee, as the audit committee is responsible for the hiring and firing of the auditor. We believe that it may be more appropriate for the Board of Directors to evaluate the effectiveness of the audit committee.
- We do not believe that there should be an assumption that an ineffective audit committee would necessarily lead to an auditor believing that a significant deficiency in internal controls exists over financial reporting in a company. While we agree that effective oversight of a company's external financial reporting and internal control over financial reporting by the audit committee should be a key component to an effective system of internal control, we note that a "significant deficiency" has been defined as an internal control deficiency that "results in more than a remote likelihood of a material misstatement in the company's financial statements". We believe it is quite possible that a company could have a very strong internal control environment in spite of weak oversight by the audit committee and that the threshold for a "significant deficiency" would not be met.
- We would like the Board to consider having separate dates for the financial statements and management's assessment of internal control over financial reporting. A requirement to have the two reports to be within 2-3 months of one another would allow both management of the company and the auditor to meet the tight reporting windows far more easily.

We appreciate the opportunity to express our views and concerns in regards to the proposed auditing standard. If you have any questions regarding our response or would like to discuss our comments, please feel free to contact me at 317-276-2024.

Sincerely,

ELI LILLY AND COMPANY

/S/Arnold C. Hanish

Arnold C. Hanish
Executive Director, Finance, and
Chief Accounting Officer

Appendix A
Response to Specific Questions

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?*

We believe that the Act requires the auditors to attest on management's assessment of the effectiveness of internal control, and not performing tests to allow them to support their own conclusion and that the scope of the audit should be limited to accomplishing their objective. There should not be a requirement for the auditor to obtain, directly, evidence about whether internal control over financial reporting is effective as this could lead to duplicitous testing and additional cost without adding value. We believe that the auditors should be allowed to use their judgment on the amount of testing that they carry out, depending on the control environment within the organization. The amount of testing for an organization with a strong controls environment should be less than one with a weaker environment.

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?

We agree walkthroughs provide the auditor with important audit evidence for purposes of confirming the auditor's understanding of the process flow of transactions and evaluating design effectiveness. However, we believe that it is reasonable for the auditor to rely on walkthroughs procedures performed by internal audit for companies with strong internal audit department. The standard should allow for the auditor to determine the control environment in a company and then use their judgment as to if they can rely on work performed by internal audit or management. We do not believe that the auditor will be able to perform a walkthrough efficiently and effectively without the help of internal audit or management.

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?

In many circumstances the processes and internal controls over these processes will be identical from year to year. We believe that it is appropriate for the auditor to use their judgment to determine the extent of testing, especially if there haven't been significant changes in the internal controls or processes.

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

We believe that the proposed standard does not utilize work that can be carried out by an independent, objective and competent internal audit department. We believe if the proposed standard is left unchanged, it could lead to a decreased recognition and reliance on the internal audit function when it comes to audit of the financial statements. We also believe that the proposed standard should allow management to assist the auditor in the performance of the walkthrough tests by providing the required documentation and evidence that the auditor requires. Alternately, the proposed standard should allow an independent, objective and competent internal audit department to carry out the walkthrough tests while the auditor observes, re-performs and/or reviews the results.

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?*

We believe that the proposed standard does not provide adequate recognition to the work of internal auditors by not allowing the external auditor to rely on the internal auditor's work. The external auditor should use his or her judgment as prescribed by SAS 65 to determine as to what extent to rely on the work of the internal auditors. In not relying on work of the internal auditors, there is a risk that the external auditor will be performing work that is both duplicitous and non-value added. In addition, there will be an increase in audit fees that would not seem justifiable for corporations with independent, competent internal audit departments. As we stated above, we believe if the proposed standard is left unchanged, it could lead to a decreased recognition and reliance on the internal audit function when it comes to audit of the financial statements.

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

Section 404 of the Act and the proposed standard focus on internal controls over the financial reporting and not controls related to compliance with regulations and laws. We do not believe that weak regulatory compliance controls necessarily mean weak controls over financial reporting. It is our opinion that controls over regulations and law are beyond the scope of the Act and of the proposed auditing standard.

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?*

We do not believe that it is appropriate for auditors to be required to evaluate the effectiveness of the audit committee. We believe that an inherent conflict of interest exists for an auditor to evaluate the audit committee, as the audit committee is responsible for the hiring and firing of the auditor. We also do not believe that there should be an assumption that an ineffective audit committee would necessarily lead to an auditor believing that a significant deficiency in internal controls exists over financial reporting in a company. While we agree that effective oversight of a company's external financial reporting and internal control over financial reporting by the audit committee should be a key component to an effective system of internal control, we note that a "significant deficiency" has been defined as an internal control deficiency that "results in more than a remote likelihood of a material misstatement in the company's financial statements". We believe it is quite possible that a company could have a very strong internal control environment in spite of weak oversight by the audit committee and that the threshold for a "significant deficiency" would not be met.

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

We believe than an inherent conflict of interest exists for an auditor to evaluate the audit committee, as the audit committee is responsible for the hiring and firing of the auditor.

EMERSON

Richard J. Schlueter
Vice President &
Chief Accounting Officer

8000 West Florissant Ave.
P.O. Box 4100
St. Louis, MO 63136-8506

T (314) 553 2327

November 20, 2003

Public Company Accounting Oversight Board
Attention: Office of the Secretary
1666 K Street, NW
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 008

Ladies and Gentlemen:

Emerson supports the goals stated by Congress underlying the Sarbanes-Oxley Act of 2002 (the "Act") to increase corporate responsibility, to improve the accuracy and reliability of corporate disclosures and to protect investors by enhancing auditor independence. We submit this letter to highlight some of our concerns with the "Proposed Auditing Standard – An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements."

Overall

We caution the Board to not overreact to the illegal acts committed by a few companies. We believe fraud is not widespread and that all of the new rules will not stop such abuses from occurring. The proposed auditing standard will significantly increase costs, distract management and the auditor, and likely still not achieve the intended objective. As the Board noted, any system of internal control can be circumvented, particularly by senior management, which inherently limits its effectiveness. No matter what laws are put in place, individuals will be able to intentionally override controls and commit fraud. Fraud most often is discovered due to someone reporting the fraud, and the Act has strengthened this by providing broad access to a company's audit committee for reporting suspected violations.

Because the Act gave the Board significant authority in implementing rules relating to accounting firm attestation standards, we urge the Board to ensure that, to the extent the Board has been left with rule-making discretion under the Act, it carefully weighs the benefits to the investing public against the burdens to be placed on issuers and their auditors by the new attestation standards.

Auditor Evaluation of Management's Assessment

We are very concerned with the cost of implementing Section 404 of the Act, which we currently estimate will cost in excess of $5 million per year on an ongoing basis. We are also concerned that the proposed rules will cause duplicative effort of testing internal control effectiveness by management and the auditor. As indicated above, we do not believe internal controls were the problem in the most recent highly publicized failures. On the other hand, we do believe recent events have caused companies to review and strengthen internal controls and this is beneficial. However, duplicate testing cannot be justified from a cost/benefit perspective.

We propose that the rules should make clear that management's assessment could be based on all of the information that it has available from operating the business and all instances of problems identified by both internal and external auditors throughout the year. Based on this information alone, management should be able to conclude, without performing detail testing, that nothing has come to its attention that leads it to believe that internal controls over financial reporting are not effective. Then, the external auditors should perform detail tests and give an opinion on internal control effectiveness.

Alternatively, management's assessment could include detail testing of internal controls using its internal audit function, while the external auditor would review such testing and provide its opinion based solely on its review of management's assessment. We believe selecting one of these two testing models, but not both, would reduce our costs by $2 million per year. In addition, companies would avoid the intangible costs of operational disruptions from being audited by both internal and external auditors each year.

Reliance on Others

If the Board decides to adopt this standard as proposed, the final standard should allow more opportunity for the external auditor to leverage the work already performed by a company's internal audit function. The proposed standard appears to allow an external auditor to use the work performed by others, including internal audit, but the limitations imposed on such reliance negate this efficiency. For example, the requirements that an auditor perform walkthroughs for all of the company's significant processes during each audit, that an auditor not rely on others for controls in the control environment, and that an auditor only place limited reliance on others for controls over nonroutine transactions eliminate the supposed flexibility provided to the auditor.

The final standard should allow the auditor greater professional judgment to determine if the work performed by others is reliable and should not mandate specific areas that the auditor may not rely on the work of others. If management does not maintain sufficient documentation of management's assessment to allow the auditor to rely on its evaluation, the auditor could perform such additional procedures, as deemed necessary, to determine whether controls are effective. The auditor would also determine whether the lack of documentation results in a material weakness.

Effective Date

The effective date should be for audits of fiscal years beginning after the final standard is adopted, since the standard requires that the auditor's evaluation of controls be interrelated with the auditor's financial statement audit. Auditors who have already begun planning for some fiscal 2004 audits, particularly for those companies several months into their fiscal years, were unable to perform the procedures that would be required by the final standard when they planned the financial statement audit.

Summary

In summary, we support a balanced approach that weighs the costs and benefits, and only requires what is necessary without becoming excessive. There is a point where incremental requirements result in minimal improvement, but at a substantial cost. Either management should perform the assessment of internal control over financial reporting and the auditor should attest to the assessment performed by management, or management should perform a limited assessment and the auditor performs more thorough testing. The Board should work with the Securities and Exchange Commission to develop a compromise, so that both management and the auditor do not have to perform detailed testing of internal control over financial reporting.

Should the Board have any questions regarding our comments, please do not hesitate to contact the undersigned. We appreciate the opportunity to comment on these issues and trust that our comments will be seriously considered in future Board deliberations on these issues.

Sincerely,

Richard J. Schlueter

Richard J. Schlueter
Vice President &
Chief Accounting Officer

SERVICES YOU COUNT ON

William L. Gipson
President and Chief Executive Officer

November 19, 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 No. 008 -
Proposed Auditing Standard - An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

Ladies and Gentlemen:

The Empire District Electric Company commends the Public Company Accounting Oversight Board (the "Board") on its proposed auditing standard relating to an audit of internal control over financial reporting (the "Proposed Standard"). Empire is an investor-owned utility providing electric service to approximately 154,000 customers in southwest Missouri, southeast Kansas, northeast Oklahoma and northwest Arkansas. Empire has been listed on the New York Stock Exchange since 1946 and is proud of its long history of responsible corporate governance.

Empire appreciates the invitation to comment on the Proposed Standard and we hope that the Board finds these comments helpful. Although we believe that most of the provisions of the Proposed Standard will help achieve the stated goals of the Board, the SEC and Congress, we strongly believe that provisions contained in paragraphs 56-59 ("Evaluating the Effectiveness of the Audit Committee's Oversight of the Company's External Financial Reporting and Internal Control Over Financial Reporting") should not be adopted for the reasons we describe below.

In addition, you have posed several questions relating to these paragraphs, including the following:

Question 22: Is it appropriate to require the auditors to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting?

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

We believe that the answer to both of these questions is an emphatic "No".

THE EMPIRE DISTRICT ELECTRIC COMPANY • 602 JOPLIN STREET • POST OFFICE BOX 127 • JOPLIN, MISSOURI 64802 • 417-625-5106 • Fax: 417-625-5153

Our rationale for requesting the elimination of paragraphs 56-59 and our answering "No" to Questions 22 and 23 are premised on our belief that the audit committee should be an independent committee which is not beholden to management or the company's auditor and that a company's auditor should be independent from the company and its board (and especially the audit committee). The recently adopted NYSE and NASDAQ rules on corporate governance, the Sarbanes-Oxley Act of 2002 and the SEC rules implementing the Sarbanes-Oxley Act all stress the importance of maintaining such independence.

In particular, Section 301 of the Sarbanes-Oxley Act, as implemented by Rule 10A-3(b)(2) states that "The audit committee of each listed issuer, in its capacity as a committee of the board of directors, must be directly responsible for the appointment, compensation, retention and oversight of the work of any registered public accounting firm engaged (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the listed issuer, and each such registered public accounting firm must report directly to the audit committee."

These rules were designed, in large part, to eliminate the conflict of interest inherent in having management engage the auditors and determine their fees. The provisions in paragraphs 56-59 would re-introduce this conflict of interest. The members of the audit committee have been entrusted with a myriad of responsibilities as a result of the new corporate governance rules, including the responsibilities described in the preceding paragraph. The committee members will not be able to effectively carry out their responsibilities if they also need to answer to and be evaluated by the auditor. Also, the auditor will not be able to effectively evaluate the audit committee because the auditor is beholden to the audit committee for its appointment. In fact, the very appearance of these inherent conflicts would undermine the public confidence goal underlying the Proposed Standards.

Further, these provisions in the Proposed Standard would introduce too much subjectivity into the auditor's audit of internal controls (i.e. the auditor would be required to evaluate the audit committee members' understanding of their responsibilities and whether or not any members are "friends" of management).

We hope that the Board finds these comments helpful. As stated above, we feel strongly that the proposals addressed above should not be adopted.

Respectfully submitted,

William L. Gipson

W. L. Gipson
pas

From: LesleeGuardino@ca.slr.com
Sent: Friday, November 21, 2003 4:21 PM
To: Comments
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Subject: Comments regarding PCAOB Rulemaking Docket Matter No. 008
Importance: High

Thursday, 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

On behalf of four leading EMS companies (Solectron, Flextronics, Celestica and Sanmina-SCI) thank you for the opportunity to express our views on the proposed *Auditing Standard , An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements.* We commend the Board for clarifying and providing specific guidelines regarding the work of external auditors in relation to Section 404 of the Sarbanes Oxley Act. We respectfully offer, and appreciate your consideration of, the following comments.

Evaluating Effectiveness of the Audit Committee

We support the PCAOB's notion to evaluate audit committee effectiveness. However, we offer the following comments:

1- We believe that it is the responsibility of the board of directors to evaluate the effectiveness of the audit committee, not the responsibility of the external auditor. We believe the evaluation of the audit committee by the external auditor presents a conflict of interest as the Sarbanes-Oxley Act makes the audit committee directly responsible for the appointment, compensation and oversight of the work of the external auditor. Therefore, we believe this standard needs to be removed.

2- If the final standard includes evaluation of the audit committee by the external auditors, we believe that the evaluation must be based on explicit measurable criteria to determine whether effectiveness requirements have been met. Therefore, we recommend developing an assessment checklist that indicates the level of a company's compliance with SEC and listing requirements.

Significant Deficiency & Material Weakness

The proposed standard has clarified and answered a number of our questions. However, we believe further clarification on the following items is needed:

- **Definition of "Senior Management"** In paragraph 126, which describes the circumstances regarded as significant deficiency there is an item referring to identification of fraud on the part of "senior management." We believe the term "senior management " needs to be specifically defined.
- **Evaluating Effectiveness of the Internal Audit Function.** We believe standards should include

specific criteria for such evaluation by external auditors. Criteria may include reporting structure, adequacy of audit group size, work experience and professional designation of audit staff.

- **Definitions.** We have some concerns regarding the clarity of the definitions of " significant deficiency " and the resulting consistent application by auditors. The proposed standard alters the definition of a " significant deficiency" and "material weakness" by substituting the term "more than a remote likelihood" for "relatively low level." These changes to definitions currently in practice may unnecessarily create confusion and inconsistency in application; therefore, we recommend that the board reconsider the definition of these terms.

Testing & Reliance on Work of Others

COSO Fundamentals Not Fully Considered. The SEC final rule on 404 requirements clearly refers to COSO as an acceptable framework. PCAOB has expressed the same position. However, in defining the level of retesting that external auditors are required to perform, and guiding auditors on the level of reliance placed on the work of internal auditors, the dynamics of COSO and its fundamentals have not fully been considered. In general, if the COSO concept of "ongoing monitoring" is performed adequately by management, then external auditors should be allowed to increase their reliance on the work done by management and the company's internal audit function.

For companies with strong COSO practices, the level of retesting recommended in the proposed rule appears excessive and the reliance on the work of internal auditors is inadequate. We believe this has opened the door to excessive audit fees and unnecessary audit procedures without a requisite benefit. A company with strong COSO framework should benefit from new standards, rather than be subject to the level of retesting proposed.

Work of Internal Auditors on Testing of Pervasive Controls is Valuable and Reliance is Warranted. We support the position of having external auditors perform certain tests without relying on others to perform a portion of their attestation work. However, we believe the notion that there could be no reliance on the work of others regarding pervasive controls and antifraud programs is ineffective and unnecessarily expensive without adding the expected value. We strongly believe that today's internal auditors possess more detailed knowledge and expertise with respect to internal controls than do external auditors. This in-depth knowledge of complex internal controls suggests that internal auditors are better prepared to test internal controls; and therefore the external auditor should be permitted to place a significant amount of reliance on the internal auditors' work. We believe that the proposed "no reliance in case of pervasive controls " creates a duplication of effort that increases costs without adding value.

Each Audit Should Build Upon the Work Performed in Prior Audits. We agree that external auditors must perform annual tests and procedures, which they believe are necessary to ensure a thorough understanding of controls and provide for the necessary assessment as to the effectiveness of those controls. However, the external auditors must be allowed the ability to exert judgment about whether the process under review is routine or does not entail a high-degree of subjectivity or judgment versus one that is either influenced by management judgment or out of the ordinary. Based on that determination, the external auditor should be allowed to determine whether the work performed in the prior year could be relied upon.

We believe the audit tests related to routine processes should involve updating procedures rather than performing complete retests without reliance on prior audit work. We strongly agree that retesting processes and controls over significant non-routine transactions, or those with a high degree of subjectivity or judgment, is warranted.

Sincerely,

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November 21, 2003

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(SENT VIA EMAIL TO: comments@pcaobus.org)

Re: Rulemaking Docket Matter No. 008

We are pleased to provide comments on PCAOB Release No. 2003-017 Proposed Auditing Standard – An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements.

EnCana is one of the world's leading independent oil and natural gas production companies with an enterprise value of approximately US$21 billion. EnCana explores for, produces and markets natural gas, crude oil and natural gas liquids in Canada, the United States, the U.K. North Sea and Ecuador. EnCana is listed on the New York Stock Exchange and the Toronto Stock Exchange.

As a foreign private issuer, EnCana's auditors will be subject to the PCAOB rules when they issue their opinion on EnCana's assessment of the effectiveness of its internal controls. In preparing for compliance with section 404 of the Sarbanes Oxley Act, EnCana has taken an overall approach to assessing internal controls that is similar to the approach proposed by the PCAOB. However, we would like to express our concerns and provide our comments on the following three matters with respect to the proposed standard.

1. Definitions

Internal Controls Deficiency

The proposed definition of internal control deficiency does not adequately recognize the inherent limitations of internal controls. The proposed rules state that even when a control operates as designed, if the control objective is not ***always*** met, an internal control deficiency exists. This definition is inconsistent with paragraphs 11 and 15 of the proposed standard which recognize that internal controls have inherent limitations and can not provide absolute assurance, only reasonable assurance.

Significant Deficiency & Material Weakness

The proposed definitions are expressed in terms of likelihood and magnitude. This is a logical way to express these definitions. However, the proposed definitions use a level of likelihood that is too low, and a new term – "inconsequential" that is not clearly defined.

The draft rules propose that companies must design and implement internal controls to provide a level of assurance that is not practical and in some instances not possible. The following example illustrates this point.

When credit is granted to customers, controls such as credit applications, credit checks, and approvals are put in place to prevent losses due to customers not making payments. However, these controls, even when functioning as designed will not always prevent losses due to customers not making payment. Also, the likelihood that a customer will not make a payment is greater than remote. Assuming that the amounts of the losses are more than inconsequential, this would be a significant deficiency.

Processes that involve estimates become even more problematic. Continuing with the example of credit and assessing the controls that ensure the accuracy of the allowance for doubtful accounts related to those receivables, even if the controls operate as designed, there will be a more than remote likelihood that the allowance for doubtful accounts is incorrect because it is an estimate. The estimate could be incorrect by more than an inconsequential amount, and this would be a significant deficiency.

We strongly urge the PCAOB to reconsider the definitions of "significant deficiency" and "material weakness" in terms of the likelihood applied to these definitions.

With respect to the impact component of the definition, we suggest that the PCAOB provide further quantitative and qualitative definitions and examples as to what constitutes "inconsequential". Without further clarification, the application of this definition will be subjective.

As stated in the definitions, the primary difference between the definition of significant deficiency and material weakness relates to the impact. Based on the examples and other parts of the proposed standard, it appears that a significant deficiency can become a material error if it is uncorrected over a period of time. This presumption does not take into consideration the cost benefit factor associated with internal controls, nor does it take in to consideration the uncertain nature of estimates. Organizations may choose to accept a more than remote likelihood of an inconsequential error if the cost of implementing such a control significantly exceeds the cost of the error.

2. Audit Committee Evaluation

We believe that it is not appropriate to have external auditors evaluate the effectiveness of the Audit Committee's Oversight of the Company's External Financial Reporting and Internal Control Over Financial Reporting. Given the recent rules and increased disclosures that are required with respect to audit committee mandates and the independence of audit committees, all work of external auditors is approved by the audit committee. Requiring external auditors to evaluate the committee that is responsible for approving their work is a conflict of interest. Assessing the effectiveness of the audit committee is a responsibility of the board of directors. In addition, shareholders have a new level of information with respect to audit committees that provide them access to information that would allow the informed investor to form their own opinions on the effectiveness of audit committees.

3. Scope of Evaluation

We believe that further guidance should be provided on the scope of the evaluation with respect to investments and subsidiaries. With the recent accounting pronouncements such as FIN 46, this area needs to be further clarified. In the oil and gas industry the use of joint ventures also creates another complexity which is not directly addressed in the proposed standard. The proposed standard discusses the scope of the audit of internal control over financial reporting in terms of significant accounts. When applying FIN 46 or proportionate consolidation, companies may find themselves with accounts that have material balances that are aggregated from many third parties. Many of these third parties may be private companies that are not subject to the requirements of Sarbanes Oxley. For these entities, management may not have access to assessing the effectiveness of internal controls, and the cost of such assessments will be significant. We ask that the PCAOB review this area further taking these factors into consideration.

Yours truly,

ENCANA CORPORATION

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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.

Question regarding the costs and benefits of internal control:

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.

Questions regarding evaluation of management's assessment:

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.

<u>Questions regarding using the work of management and others:</u>

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.

<u>Questions regarding auditor independence:</u>

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.

<u>Questions regarding auditor's responsibilities with regard to management's certifications:</u>

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.

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November 21, 2003

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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

Dear Mr. Seymour:

We are pleased to comment on the PCAOB's proposed auditing standard (the "Proposed Standard") related to an audit of internal control over financial reporting in conjunction with an audit of financial statements (an "audit of internal control over financial reporting"). Overall, we support the Proposed Standard because we believe it would provide improved guidance for auditors in the execution of audits of internal control over financial reporting. The performance and reporting guidance in the Proposed Standard is consistent with the level of assurance an audit of internal control over financial reporting is expected to provide, and the PCAOB has appropriately recognized the responsibilities of management to assess and report on internal control over financial reporting, as described in the final rule issued by the Securities and Exchange Commission (the "SEC Final Rule").

While we commend the Board for its thorough Proposed Standard, we believe the Board should modify some aspects of the Proposed Standard to address a number of key matters, including the following:

Use of the Work of Management and Others (Paragraphs 103-110)
Provide the auditor more flexibility in using the work of internal auditors, especially where "the importance of the internal audit function results in a high degree of competence and objectivity." We believe paragraph 104 unnecessarily prohibits the use of the work of management and others, particularly internal audit, in three areas—walkthroughs, controls over the period-end financial reporting process, and controls that have a pervasive effect on the financial statements, such as certain information technology general controls. We believe the auditor should be permitted to use, on a "limited basis," the work of internal audit in these areas based on the auditor's assessment of the competence and objectivity of those performing the work.

Evaluating the Effectiveness of the Audit Committee's Oversight (Paragraphs 56-59)
Clarify that the auditor's responsibility to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is not a separate and distinct evaluation. Rather, it is

one element of the auditor's overall understanding and assessment of the company's control environment and monitoring components.

Evaluating the Results (Paragraphs 8 and 21 and Appendix D)
Reconsider whether "more than inconsequential" is the appropriate threshold for identifying significant deficiencies, and the effect of this threshold on other aspects of the Proposed Standard dealing with materiality and evaluating the results of the audit of internal control over financial reporting.

Auditor's Responsibility Relating to Management's Quarterly Certifications (Paragraphs 185-189)
We believe it is inappropriate to include additional responsibilities with regard to management's quarterly certifications in this Proposed Standard, which addresses "an audit of internal control over financial reporting performed in conjunction with an audit of financial statements." We do not believe the auditor's responsibility for management's quarterly certifications and related disclosures extends beyond the responsibility to inform the audit committee of matters coming to his or her attention.

Considerations for Small and Medium-Sized Companies (Appendix E)
Further clarify how an audit of internal control over financial reporting should be conducted for small and medium-sized issuers. We believe the COSO framework currently provides management and the auditor with sufficient guidance and flexibility with regard to small and medium-sized companies. We suggest the Board modify Appendix E to refer to the COSO guidance or provide more specific examples based on the COSO guidance.

Effect of Material Weaknesses on Reporting (Paragraphs 162-164)
Permit a qualified (e.g., "except for") management assessment and audit opinion in certain cases based on an evaluation of the significance of a material weakness. As further described in our response to question 25 in a later section, we believe this reporting alternative would more clearly communicate to users of the reports the effect of a material weakness and would be consistent with the SEC Final Rule.

We also urge the Board to clearly identify the changes being made to the Board's interim professional standards as a result of the Proposed Standard, including the substantive procedures with respect to audits of financial statements described in paragraphs 138-142.

We have organized our comment letter to first respond to the 31 questions on which the Board seeks public comment and then to provide additional comments that do not relate to a particular question. Our responses and additional comments include specific observations on those matters we have highlighted above.

We believe our comments and suggestions are in the spirit of the Board's broad objectives of promoting strong corporate governance and the communication of appropriate information on internal control over financial reporting.

An Integrated Audit of the Financial Statements and Internal Control Over Financial Reporting

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?

Yes. The term "audit" appropriately denotes the level of assurance that the auditor's attestation report provides.

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?

For purposes of reporting on internal control over financial reporting under Section 404 as described in the Proposed Standard, we believe the accounting firm should be prohibited from performing an audit of internal control over financial reporting without also performing an audit of the company's financial statements as of the same date. We recognize this requirement would mean (1) the same accounting firm would have to perform both audits, (2) the audit of internal control would necessarily coincide with the entity's fiscal year end, and (3) the auditor's report on the effectiveness of internal control over financial reporting, under these circumstances, would be as of a point in time. We agree with the Board's view that the audits are closely interrelated and the auditor needs to consider the potential significance of the information that might be obtained during the audit of the financial statements to his or her conclusions about the effectiveness of internal control over financial reporting.

However, we believe there may be other situations that require an audit of internal control over financial reporting of a public company, but do <u>not</u> also require an audit of financial statements. For example, a regulatory agency or a potential buyer might require an audit of internal control over financial reporting of a public company or one or more of its subsidiaries as of a point in time that does not coincide with the entity's fiscal year end. Under these circumstances, the audit of internal control over financial reporting need not be performed in conjunction with an audit of the financial statements. To address these circumstances, we suggest the Board not supersede Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting" of Statement on Standards for Attestation Engagements No. 10 *Attestation Standards: Revision and Recodification* (AICPA, Professional Standards, Vol. 1, AT sec 501). We recommend this chapter be updated or otherwise amended as necessary for use in situations other than an audit of internal control over financial reporting in conjunction with an audit of financial statements.

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?

No. For purposes of reporting on internal control over financial reporting under Section 404 as described in the Proposed Standard, we believe the audit of the financial statements necessarily must be <u>completed</u> at the same time as the audit of internal control over financial reporting. We agree with the Board's view that the audits are closely interrelated and that the two audit reports should be dated the same (paragraph 157).

The Costs and Benefits of Internal Control

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?

We believe the COSO framework currently provides management and the auditor with sufficient guidance and flexibility with regard to how the internal control components relate to small and medium-sized companies.

While we understand the Board is sensitive to the possible effects of the Proposed Standard on small and medium-sized companies, we believe Appendix E implies that, due to the involvement and interaction of senior management, there is a lower threshold for the design of effective internal control over financial reporting and a lower threshold for evidence of operating effectiveness for small and medium-sized companies. We agree the behavior and interaction of senior management is critical to an effective control environment. However, we do not agree that it is necessarily more so for smaller or medium-sized companies and, in any event, the owner-manager should not be viewed as a replacement for necessary controls that address the relevant assertions related to significant accounts and disclosures.

While it has been our experience with audits of smaller or medium-sized companies that systems and processes often are less complex and thus generally require fewer, less formal controls, the true measure of the overall effectiveness of internal control is the consistent execution of these controls and their sensitivity to identifying potential misstatements, whether caused by error or fraud.

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.

No. We believe interim professional standards adopted by the Board provide sufficient guidance regarding the level of competence, training and professional skepticism of audit personnel, and it is not necessary to reiterate the information from these standards as has been done in paragraphs 30-38 and paragraph 111 of the Proposed Standard. We believe it would be redundant to specify in the Proposed Standard the level of competence, training, and professional skepticism of audit personnel performing specific procedures for audits of internal control over financial reporting, while similar guidance on training, professional skepticism, and supervision relating to audits of financial statements is already included in the interim general and field work standards.

Evaluating Management's Assessment

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. We agree with the Board that "an auditing process restricted to evaluating what management has done would not provide the auditor with a sufficiently high level of assurance that management's conclusion is correct." To conclude that internal control over financial reporting is effective, the auditor necessarily will need to perform sufficient procedures to determine whether he or she agrees with management that internal control is effective.

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

Yes. We believe providing criteria auditors should use to evaluate the adequacy of management's documentation will more clearly define the documentation requirements under management's responsibilities, align the approaches used by management and the auditor to evaluate internal control over financial reporting, and drive consistency in practice. For example, requiring documentation about how significant transactions are initiated, recorded, processed, and reported helps to clarify that, as part of its assessment, management is expected to identify and evaluate controls over processes or activities at the transaction level. In the absence of this requirement, management might conclude that they need only identify higher-level management controls. Such higher-level controls might not be sufficiently sensitive to prevent or detect errors relating to one or more relevant assertions.

We also agree with the Board's statement in paragraph 45 that "documentation . . . is evidence that controls related to management's assessment . . . have been identified, are capable of being communicated to those responsible for their performance, and are capable of being monitored by the company."

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?

If documentation is indeed inadequate, we agree it would be an internal control deficiency, the severity of which the auditor should evaluate. Documentation affects both the information and communication and monitoring components of internal control, providing the foundation for appropriate communication of responsibilities for performing controls and the entity's evaluation and monitoring of the effective operation of controls. Because the auditor should consider the facts and circumstances of any documentation deficiency, we believe the effect of inadequate documentation should be evaluated similar to other deficiencies in internal control and not automatically rise to the level of a significant deficiency or material weakness.

Obtaining and 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. However, we believe the requirement to "trace all types of transactions and events, both recurring and unusual" is too broad.

We believe the word "all" would require the auditor to perform extensive procedures to search for, and walk through, an extensive number of transactions regardless of their risk. Additionally, notwithstanding that tracing "all types of transactions and events, both recurring and unusual" is not feasible, we do not believe the additional procedures will aid the auditor in further understanding how a process functions and the design of the related controls. We recommend the Board include qualifying language to denote that the auditor should walk through significant classes of transactions and related controls within significant processes, and possibly offer an example to clearly demonstrate the Board's intent with this requirement.

We also suggest the Board alter the second phrase in the first sentence of paragraph 80, i.e., "controls for all five internal control components and fraud." While we agree the auditor should perform procedures to confirm his or her understanding of the design of controls and that the controls have been placed in operation, we do not believe it feasible to "walk through" controls for all five internal control components or controls intended to address the risks of fraud.

We also suggest the Board revise paragraph 82 to make it clear that, for an audit of internal control over financial reporting as of the end of the year, the auditor should, when applicable, walk through transactions that were processed after there have been significant changes in the related processes and controls during the year.

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?

No. We believe there will be many situations where internal audit will perform walkthroughs as part of management's assessment process. The auditor should consider the nature and extent of those walkthroughs in determining his or her own walkthrough procedures. For example, the auditor should be able to use walkthrough procedures related to routine processes when internal auditors who possess a high degree of competence and objectivity perform those procedures.

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?

We believe it is appropriate to require the auditor to obtain such evidence every year, because each annual audit of internal control over financial reporting needs to stand on its own.

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?

We agree with the statement in paragraph 103, "The auditor should evaluate whether to use the work performed by management or others."

We believe the auditor should be permitted, but never required, to use the work of management or others based on the auditor's assessment of the competence and objectivity of those performing the work, and the relative importance of that work to the overall audit of internal control over financial reporting. However, as further discussed in our responses to questions 13 through 15 and elsewhere in this letter, when the auditor's evaluation indicates that the individuals performing the work have a high degree of competence and objectivity (e.g., internal audit), we believe the auditor should be permitted to use this work more extensively. Similarly, the auditor should be permitted to use the work of "others" more extensively, but only when such individuals perform roles similar to internal auditors and have a high degree of competence and objectivity (e.g., a loan review function in a financial institution). This also is conditioned on the auditor re-performing a sufficient amount of the work to be satisfied as to the sufficiency of the procedures performed and accuracy of the results.

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

No. In the first category of controls, we believe paragraph 104 unnecessarily prohibits the use of the work of management and others in three areas—walkthroughs, controls over the period-end financial reporting process, and controls that have a pervasive effect on the financial statements, such as certain information technology general controls. We believe these three areas should be moved to paragraph 105, which describes procedures performed by management and others where the auditor's use of such work "should be limited." Our rationale for walkthroughs is described in our response to question 10 in this section.

We agree that certain IT general controls have a pervasive effect on other controls, and further agree that controls over the period-end financial reporting process are important to the auditor's assessment of the effectiveness of internal control over financial reporting and the detection of fraud. However, we are not convinced that the criteria in paragraph 103 should preclude the auditor from using the work of competent and objective internal auditors in these areas. The internal audit departments of public companies often include professionals with specialized skills (e.g., information technology), and who appropriately follow established professional standards in the conduct of their work. We believe the auditor's inability to use the work of these professionals potentially would detract from, rather than enhance, the quality of audits of internal control over financial reporting and, at a minimum, would unnecessarily add to the cost borne by public companies.

In the second category of controls, where the use of the results of procedures performed by management and others should be "limited," we suggest the Board clarify the extent of the use of the work of management and others it considers acceptable in these situations. In our view, it is inconsistent to conclude that internal audit is competent and objective, but then discount their training and experience when planning to use their work. While we agree that certain accounts involve significant judgments and estimates that affect the account balance or disclosure as noted in the fifth bullet in paragraph 103, it does not necessarily follow that the evaluation of all of the related processes and controls also is subjective.

In the third category of controls, the description in paragraph 106 ("other areas, such as controls over routine processing of significant accounts and disclosures") indicates the auditor might decide to use the work of "management and others *within the company*" (emphasis added). This differs from the reference to "management and others" used elsewhere in the Proposed Standard. The term "others" is defined in paragraph 42 to "include internal audit and third parties working under the direction of management, including other auditors and accounting professionals engaged to perform procedures as a basis for management's assessment." We recommend the words "within the company" be deleted.

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?

Paragraph 108 appears to give appropriate recognition to the work of internal auditors. However, we do not believe this recognition has been reflected in paragraphs 103-107. Where the auditor's evaluation indicates that the internal audit function has a high degree of competence and objectivity, we suggest the auditor be permitted to use the work of internal audit more extensively, including some areas of the audit of internal control over financial reporting where the auditor is otherwise prohibited from using the work of management (see response to question 13 above). Similarly, the auditor should be permitted to use the work of "others" more extensively, but only when such individuals perform roles similar to internal auditors and have a high degree of competence and objectivity (e.g., a loan review function in a financial institution).

15. Is the flexibility in determining the extent of re-performance of the work of others appropriate, or should the auditor be specifically required to re-perform a certain level of work (for example, re-perform tests of all significant accounts or re-perform every test performed by others that the auditor intends to use)?

We believe the flexibility in determining the extent of re-performance of the work of others is appropriate. The auditor should use professional judgment in determining the extent of re-performance based on the type of control and the assessment of the competence and objectivity of those performing the tests.

16. Is the requirement for the auditor to obtain the principal 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?

We agree that a benchmark is appropriate; however, we suggest the Proposed Standard be revised to explicitly state that meeting the "principal evidence" requirement is based on qualitative, not just quantitative, factors.

Evaluating the Results

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?

We acknowledge the Board's effort to improve the definition of a significant deficiency and material weakness. We believe the focus in the definitions on the magnitude of the potential misstatement and the likelihood of their occurrence, along with the examples provided in Appendix D, have the potential for increasing consistency in the evaluation of internal control deficiencies. While we believe the auditor's consideration of the likelihood of occurrence is clear, we believe the auditor's consideration of magnitude requires further clarification.

We believe the examples in Appendix D generally are consistent with the definition of a significant deficiency in paragraph 8—that is, "a misstatement of the annual or interim financial statements that is more than inconsequential." However, the definition in paragraph 8 appears to conflict with the materiality discussion in paragraph 21, which indicates that materiality at the individual account-balance level is relevant to deciding whether a deficiency represents a significant deficiency. While the term "inconsequential" in paragraph 8 is not defined, we believe it implies a lower threshold than individual account-balance materiality. We suggest the Board define the term "inconsequential" in paragraph 8 and otherwise provide clarification on the interrelationship of these two materiality concepts. We believe auditors will continue to need to use significant professional judgment in determining whether a deficiency represents a significant deficiency and suggest that the Proposed Standard acknowledge this.

We believe the inclusion of the phrase "annual or interim" in paragraphs 8 and 9 causes confusion as to the intended scope of an audit of internal control over financial reporting. The phrase is not defined elsewhere in the Proposed Standard, and it is unclear how the phrase "period-end financial reporting process" as used in paragraphs 41 and 43 relates to "annual or interim financial statements" in paragraphs 8 and 9.

If it is the Board's intention that the scope of management's assessment process and the auditor's audit procedures address controls over both the preparation of interim financial statements and year-end financial statements, we suggest that it be made clear in paragraph 41 describing the scope of controls that are to be evaluated. We also recommend the Board clarify the relationship of the auditor's responsibilities for evaluating internal control over interim financial statements with the auditor's responsibilities with respect to interim financial statements described in SAS No. 100, *Interim Financial Statements*.

Further, we believe the Proposed Standard is not clear regarding whether the phrase "annual or interim" is intended to change the concept of materiality, because this phrase suggests that materiality needs to be determined based on quarterly as well as annual financial results. Materiality in an annual audit of financial statements generally is based upon the annual financial results. In an integrated audit, we believe it is both inappropriate and inconsistent to require materiality at a much lower level (i.e., interim financial results) for purposes of the audit of internal control.

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?

Yes. The examples demonstrate a consistent thought process the auditor should employ in determining whether control deficiencies are either a significant deficiency or material weakness.

We suggest the Board consider also providing one or more examples where the likelihood of material misstatement is remote, resulting in the conclusion that a significant deficiency does not represent a material weakness even when the magnitude of potential misstatement is material. We believe these additional examples would help auditors better understand how to apply the concepts of likelihood and magnitude together when evaluating deficiencies in internal control.

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

Yes.

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?

We do not believe the auditor should be required to communicate all internal control deficiencies to management in writing, and therefore suggest this requirement be eliminated.

We believe it is appropriate that all internal control deficiencies that are identified by the auditor and of which management is unaware should be communicated to management. In our view, however, requiring the auditor to communicate deficiencies regardless of who first identified them would create confusion when the deficiencies already have been reported to management internally (e.g., by internal audit). Management has the primary responsibility for implementing an effective system of internal control over financial reporting and for assessing its effectiveness at the end of the most recent year. Accordingly, we believe the auditor should first determine whether the company has implemented a process that provides for the communication of internal control deficiencies to appropriate levels of management on a timely basis.

Under the COSO framework, internal control should be self-monitoring and self-correcting. There should be an expectation that internal control deficiencies identified through ongoing monitoring activities (as well as the annual assessment of internal control over financial reporting required by the Act) are raised to appropriate levels of management. We believe it would be more appropriate for the auditor, as part of his or her evaluation of internal control over financial reporting, to determine that internal control deficiencies identified by the company through its monitoring activities and annual assessment are reported to appropriate levels of management in a timely manner. We also suggest the Board acknowledge that the lack of an internal process to report deficiencies in internal control to management on a timely basis represents an internal control deficiency that should be evaluated for severity by the auditor.

Requiring the auditor to report all deficiencies to management in an environment where control deficiencies are already routinely raised to management potentially detracts from the relevance of the auditor's work and management's monitoring activities and undermines the Board's promotion of strong corporate governance through effective systems of internal control.

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

We do not agree that all the matters listed are necessarily strong indicators that a material weakness in internal control exists. We believe the auditor needs to first gain an understanding of the facts and circumstances of the matter. In this regard, we suggest that the Board clarify whether the evaluation would be different if the matters discussed in paragraph 126 were detected by the company's system of internal control or by the auditors in the performance of their procedures. For example, the identification of fraud on the part of senior management by the company's system of internal control might indicate that internal control is operating effectively rather than indicating a significant deficiency or material weakness. Moreover, a presumption that the identification of fraud of any magnitude on the part of senior management is at least a significant deficiency fails to adequately consider the inherent limitations of internal control.

We suggest the Board clarify or provide examples of the instances when restatement of previously issued financial statements to reflect the correction of a misstatement should be regarded as at least a significant deficiency in internal control over financial reporting. For example, we believe a restatement to reflect the SEC's subsequent view of an accounting matter when the auditor concluded that management has reasonable support for its original position would not necessarily be a significant deficiency in internal control over financial reporting. Also, we believe a restatement relating to a nonrecurring transaction in a prior year would not necessarily reflect a material weakness in internal control over financial reporting in the current year.

We also suggest the Board clarify that identification by an auditor of a material misstatement in the current period before all of management's controls had an opportunity to function would not necessarily result in a conclusion that a significant deficiency exists in internal control over financial reporting. For example, it is normal for the auditor to perform his or her review and other procedures relating to year-end financial statement information at about the same time that management performs its review and other procedures. In this situation, the auditor might identify a material misstatement in draft financial statements while the corporate controller, chief financial officer, and other members of executive management are still completing their respective reviews and other procedures. Therefore, we believe the second bullet in paragraph 126 is impractical as stated, in that it would require the auditor to consider whether the reviews and other procedures performed by the company's executives (i.e., a higher-level detect control) would have identified the material misstatement. In effect this would require the auditor to predict the future functioning of the company's controls.

While some controls that focus primarily on compliance with laws and regulations also might have a material effect on the reliability of financial reporting, we do not believe assessing the effectiveness of a company's regulatory compliance function is within the scope of an audit of internal control over financial reporting. As noted in the SEC Final Rule, the definition of internal control "does not encompass the elements of the COSO Report definition that relate to . . . a company's compliance with applicable laws and regulations, with the exception of compliance with the applicable laws and regulations directly related to the preparation of financial statements, such as the Commission's financial reporting requirements."

We suggest the auditor's consideration of the effectiveness of the internal audit function for larger, more complex entities also consider the focus of the internal audit function. We observe that some internal audit functions, while effective, primarily focus on internal control objectives other than financial reporting and thus do not necessarily contribute as much to effective internal control over financial reporting.

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?

We believe the audit committee plays a critical role. Like the independent auditor, the audit committee is independent of management. However, the audit committee is not a separate component of the company's system internal control. The system of internal control should function without the direct involvement of the audit committee. The audit committee's role, like the independent auditor's, is an evaluative one.

We agree that the auditor's assessment of the control environment and monitoring components should consider the effectiveness of the audit committee's oversight role, but only as it relates to the audit committee's assessment of *management's* approach to designing, implementing and monitoring internal control over financial reporting. For example, as part of the assessment of the control environment, the auditor generally would consider whether the audit committee appropriately reacts when management fails to respond appropriately to control deficiencies or other matters.

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

We believe the auditor can evaluate aspects of the audit committee’s oversight role as part of the company’s control environment and monitoring components of the system of internal control over financial reporting. However, the Proposed Standard would require the auditor to evaluate certain aspects of the audit committee’s oversight for which objective and measurable criteria are not provided in the Proposed Standard (e.g., clarity with which the audit committee’s responsibilities are articulated and how well the audit committee and management understand those responsibilities). In addition, when assessing the effectiveness of the audit committee’s oversight, the quality of the time and effort put forth by the committee members, and the way they react to and interact with management and the independent auditors in dealing with critical issues, is arguably more important than the amount of time spent on various activities. Finally, there are other aspects of the audit committee’s oversight that involve legal determination (e.g., independence of audit committee members from management, compliance with applicable listing standards).

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. While the auditor always has the option to withdraw from an engagement, we do not believe it would be appropriate for the standard to require the auditor to withdraw in this situation. Requiring the auditor to withdraw without first providing the company’s board of directors the opportunity to react to the matter could cause irreparable harm to the company and its shareholders.

Forming an Opinion and Reporting

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?

We believe it would be consistent with the SEC Final Rule for management and the auditor, in certain circumstances, to issue a qualified assessment and opinion about the effectiveness of the company's internal control over financial reporting (i.e., internal control is effective “except for” an identified material weakness).

Section II.B.3.c of the SEC Final Rule and related footnote no. 72 states,

> “The final rules therefore preclude management from determining that a company’s internal control over financial reporting is effective if it identifies one or more material weaknesses in the company’s internal control over financial reporting. This is consistent with interim attestation standards. See AT sec. 501.”

We believe this reference to the interim attestation standard in the SEC Final Rule is referring to AT sec. 501, par. 37, which states in part,

> "Therefore, the presence of a material weakness will preclude the practitioner from concluding that the entity has effective internal control. However, depending on the significance of the material weakness and its effect on the achievement of the objectives of the control criteria, the practitioner may qualify his or her opinion (that is, express an opinion that internal control is effective "except for" the material weakness noted) or may express an adverse opinion."

Our reading of the SEC Final Rule and the interim attestation standard leads us to conclude that it would be appropriate for the auditor to express either an adverse opinion or a qualified "except for" opinion about the effectiveness of the company's internal control over financial reporting depending on the circumstances. See our response to question 26 for an example of where a qualified opinion might be appropriate.

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

Yes. We believe that management and auditors might encounter situations in practice where a qualified "except for" conclusion would be appropriate, as it would provide more meaningful information to investors. For example, a company may have adopted a new accounting principle in the current year, which required a material audit adjustment. The auditor concluded that this adjustment resulted from a material weakness, but the material weakness was confined to one significant account. The company otherwise has effective internal control over financial reporting. We believe an auditor's report with a qualification explaining the material weakness, rather than an adverse opinion on the effectiveness of internal control over financial reporting as a whole, would provide more meaningful information to investors.

27. Do you agree with the position that when the auditor issues a nonstandard 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?

Yes. We also suggest the Board require in all cases that the auditor's opinion speak directly to the effectiveness of the internal control over financial reporting. We believe such a requirement would help to address potential misconceptions as to the scope and objective of an audit of internal control over financial reporting.

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?

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

No. We do not believe it is appropriate to include specific independence guidance in the Proposed Standard. We believe all independence guidance should be located in a discrete section of the professional standards and it would be helpful to refer to this guidance where appropriate in the Proposed Standard. We also believe current SEC independence rules and related SEC interpretations (e.g., Frequently Asked Questions) are sufficient in the context of this Proposed Standard, and potential changes to or further interpretation of such rules and interpretations should be subject to separate notice and comment rulemaking.

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?

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

We believe it is inappropriate to include additional responsibilities with regard to management's quarterly certifications in this Proposed Standard, which addresses "an audit of internal control over financial reporting performed in conjunction with an audit of financial statements." Additional requirements relating to the auditor's quarterly review responsibilities should be separately proposed and exposed for public comment.

We do not believe the auditor's responsibility for management's quarterly certifications and related disclosures extends beyond the responsibility to inform the audit committee of matters coming to his or her attention. We believe a requirement for the auditor to describe in his or her report the reasons the auditor believes management's certification should be modified would create an inappropriate dual-reporting responsibility and imply the auditor's responsibility extends beyond the scope of his or her audit report on internal control over financial reporting.

Additional Comments

Our additional comments are organized by corresponding paragraph number of the Proposed Standard.

Par. 10—The definitions of preventive and detective controls state these controls have the objective of either preventing or detecting a misstatement. We suggest that preventive and detective controls have the objective of preventing or detecting errors or fraud that could result in a misstatement of the financial statements. We believe there are many types of controls that are relevant to the overall effectiveness of internal control over financial reporting for which it may be difficult to identify a direct relationship to potential misstatements in the financial statements. For example, edit or range checks over the input of transaction data that help assure that transaction files are accurate are fundamental controls in an effective system of internal control over financial reporting, but do not have a direct bearing on preventing misstatements in the financial statements. The definitions of preventive and detective controls in the Proposed Standard may cause management or the auditor to exclude controls important to assessing the overall effectiveness of internal control over financial reporting.

Par. 14—We suggest clarifying the wording of this paragraph to state: (1) the COSO framework identifies three primary objectives of internal control (i.e., efficiency and effectiveness of operations, financial reporting, and compliance with laws and regulations) and an audit of internal control over financial reporting is concerned with only the financial reporting objective, and (2) the controls that management designs and implements may achieve more than one objective.

Par. 16—We suggest practitioners and other parties might find the correlation of reasonable assurance to "a high level of assurance" confusing and it may be appropriate to further clarify this concept in the Proposed Standard. We suggest the Board analogize the audit of internal control to the audit of financial statements where traditionally an "audit" of financial statements provides a high level of assurance while a "review" of financial statements provides a moderate level of assurance.

Par. 24—This paragraph states "the auditor should review all controls specifically intended to address the risks of fraud that are reasonably likely to have a material effect on the company's financial statements." We believe the word "all" is too broad and potentially would require the auditor to review controls that are not relevant to the audit of internal control over financial reporting. Further, the requirement to review "all" controls potentially conflicts with the requirement to place "special emphasis on the evaluation of such controls in the control environment," which implies that some of the controls management may have implemented to specifically address the risks of fraud are more relevant than other controls.

We suggest the Board remove the second bullet, "Company's risk assessment processes," as it is not part of the control environment. We also suggest changing the wording in the fourth bullet point to change the focus from functional reporting, which is not defined, to a focus on direct reporting to the audit committee and the audit committee's involvement and interaction with internal audit. We believe the wording in this bullet point should be consistent with the description in the fourth bullet point in paragraph 57 relating to audit committee oversight of the internal audit function. Finally, we suggest the Board clarify the terminology in the first bullet point, "controls restraining the inappropriate use of company assets."

Par. 41—We believe the examples of procedures management may use to evaluate the operating effectiveness of controls in the fifth bullet point of this paragraph do not reflect the full range of procedures management may employ. For example, the COSO framework indicates management might be able to determine that controls operate effectively through direct and ongoing monitoring of the functioning of controls. This might be accomplished through regular management and supervisory activities, monitoring adherence to policies and procedures, and other routine actions. While we agree with the Board's statement in paragraph 18 that "users of the reports from management and the auditor are entitled to receive the same level of assurance from management and the auditor," we believe management's daily interaction with the system of internal control provides it with a broader array of procedures to achieve that level of assurance.

Par. 50—The word "should" in the last sentence of the bullet point discussing the control environment creates a presumptively mandatory obligation (based on the terminology in the Board's Proposed Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards*) on the part of the auditor to alter the nature, timing, or extent of tests of operating effectiveness without first considering the effects, if any, of the weakness noted in the control environment on the effectiveness of other controls. This presumptively mandatory obligation to alter the nature, timing, and extent of tests of controls also may be inappropriate if the auditor already had designed tests sufficient to detect such effects, if any.

Par. 51-52—We agree that the objective of an audit of internal control over financial reporting is to evaluate the overall effectiveness of internal control over financial reporting and not to evaluate individual controls in isolation. Accordingly, the auditor also has to consider that certain internal controls (e.g., higher-level monitoring controls) often are dependent on the functioning of other controls or work in combination to achieve the objectives of effective internal control. However, it is not clear how the concepts discussed in paragraphs 51 and 52 are consistent with the requirement stated in paragraph 27, and other places throughout the Proposed Standard, that the auditor "must 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."

We suggest the Board clarify how the auditor should apply the concepts in paragraphs 51 and 52 in light of the focus on assertions in paragraph 27.

Par. 53-54—We suggest the Board reverse the order of these paragraphs to better set up the discussion of company-level controls.

Par. 62-63—We suggest the Board clarify the use of the term "component" in these two paragraphs. Paragraph 62 refers to a component as a portion of an account balance (for example, the allowance for doubtful accounts and trade receivables are components of the net trade receivables account balance). Paragraph 63 refers to a component as the corresponding account balance of a business unit. We suggest the Board not refer to corresponding account balances of individual business units as significant accounts as this implies that the determination of significant accounts should be based on individual locations or business units, rather than at the financial-statement level.

Par. 72—We suggest the Board clarify in the last bullet point under this paragraph, or elsewhere in the Proposed Standard, the contemplated nature and extent of involvement of the audit committee in the period-end financial reporting process. Is the Board suggesting that the audit committee's involvement extend beyond its oversight role for the external financial reporting process to include some level of involvement or oversight in the aspects of the financial reporting process discussed in paragraph 51 of AU319?

Par. 91—We recommend the Board provide additional examples of information that inquiries might provide, including 1) the skill and competency of those performing the control, 2) the relative sensitivity of the control to prevent or detect errors, and 3) the frequency with which the control operates to prevent and detect errors.

Par. 92—We suggest the Board incorporate a similar discussion in paragraph 41 to indicate that in performing its assessment, management also should not rely solely on inquiry and should obtain sufficient evidence through other procedures, including inspection and re-performance.

Par. 97—We do not find this paragraph helpful and suggest the Board consider combining it with another paragraph.

Par. 102—See comment on paragraph 16 in this section. We suggest the phrase "high level of assurance" may be confusing to practitioners in that the concept is being used in a different context in this paragraph than used elsewhere in the Proposed Standard. The phrase "high level of assurance" applies to the auditor's overall opinion on internal control in paragraph 16 and we do not believe the concept is relevant to the individual tests of operating effectiveness of controls.

Par. 103, 107-108—We suggest the Board move the discussion of the competence and objectivity of "individuals performing tests of controls" in paragraph 107 and "internal auditors who follow the *International Standards for the Professional Practice of Internal Auditing* issued by the Institute of Internal Auditors" in paragraph 108 so that it follows the general discussion of evaluating whether to use the work of management and others in paragraph 103, and precedes the discussion of the three categories for using the work of management and others discussed in paragraphs 104-106. We believe this positioning will better demonstrate that the auditor should consider, regardless of the category of controls, both the subject matter of the work of management and others and the competence and objectivity of those performing the work in evaluating whether to use the results of procedures performed by others.

Please see our other comments related to these paragraphs in our responses to questions 12-14 in the previous section.

Par. 113—We suggest the Board change the second bullet point to denote that only negative results derived from substantive procedures (for example, recorded and unrecorded adjustments resulting from performing these procedures) provides evidence relevant to the audit of internal control over financial reporting. This change would be consistent with paragraph 144 that states, "The absence of misstatements detected by substantive procedures does not provide evidence that controls related to the assertion being tested are effective."

Par. 124—We believe the requirement that auditors, when evaluating the significance of a deficiency in internal control over financial reporting, "also should determine the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs," applies a different definition of a significant deficiency than provided in paragraph 8. Paragraph 8 sets the threshold as a matter "that adversely affects the company's ability to initiate, record, process, or report external financial data." We believe the difference in the definitions in paragraphs 8 and 124 is more than subtle and recommend the Board address this difference in the final standard.

Par. 136-137—We do not believe it is likely that the auditor would perform further tests of controls in the audit of the financial statements in response to identified control deficiencies as a result of tests performed in the audit of internal control. Additionally, we question the necessity of these two paragraphs.

Par. 138-142—We believe the discussion in these paragraphs regarding substantive procedures performed in the conduct of an audit of financial statements is not relevant to an audit of internal control over financial reporting. We also believe certain elements of the discussion in these paragraphs suggest requirements for the audit of financial statements that exceed current requirements under interim auditing standards, and should not be introduced in a standard devoted to auditing internal control over financial reporting. For example, in paragraph 138, the Board states, "the auditor should perform substantive procedures for all relevant assertions for all significant accounts and disclosures." Under existing interim auditing standards (AU 319.107), the auditor should perform substantive procedures for "significant account balances and transaction classes" (but not necessarily for all relevant assertions).

We suggest the Board revise paragraph 141 to indicate that the auditor's substantive procedures should include testing management's process for reconciling the financial statements to the accounting records. In addition, paragraph 139 refers to the term "significant risks" but does not define it.

We urge the Board to clearly identify all the changes being made to the Board's interim professional standards as a result of the Proposed Standard. Inclusion in the Proposed Standard of important performance requirements for auditors that relate to, or differ from, interim professional standards without clearly identifying such changes and their applicability increases the risk that such changes might not be fully understood. We also urge the Board to consider whether certain of these matters should be exposed for public comment separately rather than making "conforming" changes to interim professional standards that have not been previously identified in the Proposed Standard.

Par. 145—We suggest the Board include a discussion in the Proposed Standard as to the types of documentation of the entity's systems and controls the auditor should retain in the working papers to support his or her assessment of the design and operating effectiveness of internal control over financial reporting. We believe this is particularly important in light of the extensive documentation that management will prepare to support its assessment of the design and operating effectiveness of internal control over financial reporting. For example, will it be appropriate for the auditor to refer to management's documentation or should the auditor include copies of all items of management documentation relevant to his or her evaluation of internal control over financial reporting? If the auditor can refer in his or her working papers to management's documentation, should the auditor obtain management's agreement that it will retain such documentation in its current form for a period of no less than seven years? If the auditor intends to use the results of testing performed by management and others, does he or she need to retain copies of the original working papers documenting the performance of and conclusions from these tests?

Par. 168—We believe the premise for this paragraph is incorrect, because an audit of internal control over financial reporting performed under this Proposed Standard will be in conjunction with an audit of the financial statements. The decision as to principal auditor would be made based on an analysis of the facts and circumstances relating to the audit of the financial statements.

We also suggest this paragraph discuss the situation where the decision whether to make reference to another auditor in the report on the audit of internal control over financial reporting might differ from the corresponding decision as it relates to the audit of the financial statements. For example, the audit report on the financial statements may make reference to the audit of a significant equity investment, but the report on internal control over financial reporting would not make a similar reference because management's evaluation ordinarily would not extend to controls at the equity method investee.

Par. 181-182—We suggest the Board provide additional guidance on the specific procedures to perform when the auditor is consenting to the inclusion of his or her report on internal control over financial reporting in a securities filing.

Par. 186—We suggest the Board state in paragraph 186 that foreign private issuers filing Forms 20-F and 40-F are not subject to quarterly reporting requirements and therefore the auditor's responsibilities would only extend to the certifications in the annual report.

Par. 194—The discussion of the effective date of the Proposed Standard does not make clear when the responsibilities for evaluating management's certification disclosures described in paragraphs 183-189 are first applicable. For instance, for a calendar-year issuer that is required to include its first report on internal control in its annual report for the year ended December 31, 2004, would these responsibilities commence in the first quarter of fiscal 2004 or the first quarter of fiscal 2005?

Appendix B—We suggest the Board clarify that the performance requirements and guidance in Appendix B only apply to an audit of internal control over financial reporting and do not apply to an audit of financial statements.

Appendix B, Par. B11—We understand this paragraph is meant to require that the auditor first identify, evaluate, and test controls at individually important locations and business units, including those business units or locations where there are specific risks. However, the paragraph states if this approach does not result in the auditor testing a *large portion* of the company's operations and financial position, he or she should expand the number of business units and locations evaluated in this manner. We suggest the Board clarify the term "a large portion" in this paragraph to better define what is considered an appropriate threshold.

Appendix B, Par. B13—We recommend the Board clarify whether "company-level" controls in the table refer to the same controls described in paragraph 53, or a narrower subset of those controls. If they are a subset, we recommend changing the terminology in the table to reflect the difference.

Appendix B, Par. B14-16—We suggest the Board provide guidance indicating that certain entities that are not service organizations as defined in AU324 but which provide information affecting the financial statements of the issuer (e.g., amounts covered by reinsurance contracts, information provided by actuaries) are not within the scope of the company's assessment of internal control over financial reporting.

Appendix B, Par. B15—We suggest the Board clarify in the last sentence of this paragraph those situations where management's evaluation of internal control over financial reporting would extend to controls at an equity method investee. Otherwise, we suggest the Board delete the word "ordinarily."

Appendix B, Par. B18—We believe the example is inappropriate. If an account is material to the financial statements, the account should be significant to both the audit of the financial statements and the audit of internal control over financial reporting.

Appendix B, Par. B24-39—We have the following observations and recommendations regarding the section titled *Use of Service Auditor's Report*.

The title of this section should be changed from *Use of Service Auditor's Report* to something such as *Use of Service Organizations*. The use of a service auditor's report is only one way of obtaining the required information when the company uses a service organization. This section should address (1) when a service organization is important to the audit of internal control over financial reporting and (2) what management and the auditor should do for purposes of the audit of internal control over financial reporting when a service organization is used.

It is not clear how this section relates to the existing guidance in AU324. For example, these paragraphs summarize certain (but not all) material in AU324 and, in doing so they alter the current content of AU324. For example, paragraph B27 states:

"Paragraph .07 of AU324, Service Organizations, describes the procedures that management and the auditor should perform with respect to the activities performed by the service organization, which include:

- Obtaining an understanding of the controls at the service organization that are relevant to the company's internal control over financial reporting, and
- Obtaining evidence that the controls that are relevant to management's assessment and the auditor's opinion are operating effectively."

However, AU324.07 does not contain this guidance, but instead includes guidance on how a service organization affects the understanding needed by the auditor in planning the audit. In the context of AU324, this clearly means the procedures to obtain evidence to support the opinion on the financial statements, not to express an opinion on internal control, because AU324 was never intended to address the "audit of internal control." Further, there are several references to the "audit" in this section (e.g., paragraphs B29, B31, B32, B33), without clarifying whether this guidance replaces or merely changes the existing (and more complete) guidance in AU324 regarding the procedures to obtain evidence to support the opinion on the financial statements. Finally, this section appears to modify the opening paragraphs of AU324 that define when a service organization is part of the company's information system (e.g., B26 and AU324.03).

We believe the proposed rules should (1) refer to AU324 for definitions of terms and guidance on the procedures the auditor should perform in obtaining evidence to support the opinion on the financial statements, and (2) include only additional considerations and additional (or changed) procedures required to support an opinion on internal control.

Additional specific comments on this section are:

1. Paragraph B26—Should the word "reported" in the second bullet be "recorded?"

2. Paragraph B27—In addition to misstating the material in AU324.07 as described above, the phrase "nature, timing and extent of evidence" is unclear. We believe this should be changed to something such as "nature, timing and extent of procedures to obtain evidence."

3. Paragraph B28—This paragraph does not recognize the fact that the service organization has a relationship with the "user organization," not the "user auditor" (which are defined terms in AU324.02.) We believe one of the fundamental changes in the relationship between the service organization, its users, and auditors resulting from Section 404 reporting is that the user organization—that is, the company making the assessment on internal control—now has a vital interest and need to obtain information about the controls at a service organization to support its assessment. We believe this paragraph misses this point. The service organization may do things to assist both its user—the company—and the auditor.

4. Paragraph B30—The summary of the SAS 70 opinion is incomplete. It omits the very important portion of the opinion that the controls described have been placed in operation.

5. Paragraph B31—The statement, "this report does not provide any evidence of the operating effectiveness of controls," changes the guidance in AU324.12 that states, "Such a report is not intended to provide any evidence of the operating effectiveness of the relevant controls." This is an example of the difficulty of paraphrasing or summarizing the material in existing standards. We believe it would be better to simply refer to existing AU324 than to restate it in different words that will inevitably have different meanings. However, if this standard does summarize or restate existing guidance in the interim standards, we believe it is imperative that those standards be amended to reflect the conforming changes being made through the new standard being adopted by the Board.

6. Paragraph B32—The first half of this paragraph summarizes the existing guidance in AU324.18-19; however, it does not contain all of the guidance. Again, we believe the Proposed Standard should clearly indicate how existing guidance is being changed. Further, this paragraph does not refer to management. As noted above, we believe one of the fundamental changes resulting from Section 404 reporting is that management also has a need for information about the service organization's controls to support its assessment. The last half of B32 is flawed in that it refers only to the auditor's needs.

7. Appendix B, Paragraph B33—We suggest the list of sources of information for the auditor described in this paragraph include the documentation and evaluation of controls at the service organization that management obtains as part of its required assessment of internal control over financial reporting as described in paragraph B25.

Appendix C—We believe the material in Appendix C raises many questions as to the scope of controls over the safeguarding of assets that are to be included in the assessment of internal control over financial reporting. We recommend the Board clarify that material weaknesses relating to controls over the safeguarding of assets would exist only when the company does not have effective controls (considering both safeguarding and other controls) to prevent or detect a material misstatement of the financial statements.

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We would be pleased to discuss our comments with members of the Public Company Accounting Oversight Board or its staff.

Very truly yours,

Ernst + Young LLP

Date

21 November 2003

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Office of the Secretary
Public Company Accounting Oversight Board (PCAOB)
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Dear Sirs,

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"

FEE (Fédération des Experts Comptables Européens – European Federation of Accountants) is pleased, as the representative organisation of the European accountancy profession, to comment on the exposure draft released by the PCAOB on 7 October 2003 on "Proposed Auditing Standard – An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements" (referred to as "the proposed standard").

Because of the importance of the issues raised by the proposed standard we are sending a copy of our response to the International Auditing and Assurance Standards Board (IAASB) and the European Commission. In summary, we believe that the PCAOB's rulemaking on the subject of internal control over financial reporting would be enhanced by:

- taking account of global developments in auditing standards designed to serve the interests of investors;
- considering whether the practical application of the proposed standard will encourage management to identify and resolve financial reporting issues in a timely and appropriate manner;
- ensuring that the work performed by auditors to report on financial statements is not duplicated or made less effective;
- reflecting and encouraging the adoption by management of best practices in internal control that are cost-effective and widely accepted;
- emphasising the need for auditors to take responsibility for exercising professional judgement; and
- explaining how auditors' reports on internal control over financial reporting (and adverse opinions in particular) are expected to restore confidence in capital markets.

In addition to our response to the questions set out in the request for comments to the proposed standard, this letter includes our overall comments on matters of principle. Some of our overall comments are reflected on a stand-alone basis in the next section. Other areas of significant concern have been addressed in our responses to the questions. They have been referenced separately hereafter and are all of equal importance.

Overall comments

(a) Worldwide repercussions of proposed standard

The proposed standard will have a very wide impact not only on US-based auditors, but also on auditors throughout the world serving:

(1) SEC foreign registrant companies who choose to be listed in the US; and

(2) the relevant subsidiaries of US domestic SEC registrants which fall under the same requirements as the US domestic portion of the entity.

Both types of registrants will require management and auditors to obtain the required coverage for management's assessment of and the auditor's attestation of the effectiveness of internal control over financial reporting.

The pervasive impact of the proposed standard on global audit practice and, potentially, on the platform used by global audit firms for their audit methodologies places a significant responsibility on the PCAOB in finalising the proposed standard. We believe there are significant potential shortcomings in the process.

We respectfully suggest that, with a 45 day consultation period for such an important and far reaching standard, the PCAOB is operating to inappropriate deadlines for due process and consultation that are inferior to those followed by the IAASB.

When discharging its onerous responsibility for this standard, we request the PCAOB to give due consideration to the impact its proposals will have on the IAASB's global audit standards. In particular, we strongly encourage the PCAOB to consider how the proposed standard fits in with International Standards on Auditing (ISAs). For example, there appear to be inconsistencies with the new risk ISAs which have recently been issued and agreed by the IAASB after an extensive joint project with the American Institute of Certified Public Accountants (AICPA). These ISAs should be carefully taken into account and integrated in the proposed standard.

(b) Conflict over who finds the adjustments

The proposed standard requires the auditor to issue an adverse opinion regarding the effectiveness of internal control over financial reporting should one or more material weaknesses arise.

Circumstances presumed to be at least a significant deficiency and a "strong indicator" of a material weakness include identification by the auditor of a material misstatement in the year-end financial statements that was not identified by the company's internal controls, even if management subsequently corrects the misstatement prior to issuance of the financial statements.

As a consequence, we would hope that management raises and discusses any likely issues at an early stage with its auditors to reach an agreement on the most suitable resolution for any issues.

Unfortunately, in practice, we are afraid that this increased likelihood for an adverse auditor's opinion might lead to quite the opposite result. Typically, the auditor commences his audit long before management has approved the financial statements and management will provide the auditor with a draft. While the auditor performs his audit work on this draft, management continues their checks and controls of processes and systems to ensure the draft financial statements are fairly presented. During this time of progressing the preparation and the audit of the financial statements simultaneously, either management or the auditor might uncover material adjustments.

Where there is the need for an adjustment there will be a strong incentive for management to claim that they "found it first" or would have done, had they had time to complete there own checks. The proposed standard is also likely to increase management resistance to auditor proposed adjustments because under the proposed standard, each such adjustment recorded by management would result in an adverse auditor's opinion regarding the effectiveness of internal control over financial reporting.

It even may make it impossible for the auditor to perform his work as management may try to defer the audit as long as possible until management is fully ready with the preparation of the financial statements in order to ensure that the auditor is not the first in identifying adjustments. We do not believe that this will contribute to restoring confidence in the capital markets.

(c) Two audits

The guidance provided in the new risk ISAs whereby significant risks are identified to determine which internal controls should be the subject of further audit work is not reflected in the proposed standard which requires auditors to perform audit work on all internal controls regardless of their risk profile.

The guidance in paragraphs 133 to 144 is meant to interrelate the two audits, i.e. the attestation on management's assessment of the effectiveness of internal control over financial reporting and the audit of the financial statements. However, the integration of both audits and their purpose should be enhanced. The objective of an audit of internal controls should be to form a judgement on the control risks which are part of the financial statement audit. The concepts of materiality and complexity should be introduced whereby the testing of internal control systems should only be performed for material and complex assertions, transactions, account balances and disclosures. Substantive procedures may suffice for other transactions and balances. The proposed standard currently appears to require both tests of controls and substantive procedures for all assertions, accounts and disclosures.

(d) Reasonable assurance is not high assurance

Paragraph 16 implies that "reasonable assurance" is a high level of assurance. We disagree with the PCAOB's point of view which is also at odds with the IAASB's latest thinking. There is a range of levels of assurance in relation to different aspects of financial reporting, each of which is "reasonable" when considered in context, as certain aspects are inherently more risky than others.

The level of assurance that the auditor can obtain depends on the circumstances. For example, the assurance that can be obtained by the auditor in relation to the absence of material misstatements caused by management fraud involving collusion with external parties will be considerably less than if the misstatement results from human error in routine processes.

FEE has considered these matters in detail in its April 2003 Issues Paper "Principles of Assurance: Fundamental Theoretical Issues with Respect to Assurance in Assurance Engagements".

(e) Assertions too prominent

Financial statements are meant to report on the status and progress of the business of an entity for the benefit of stakeholders including investors and are not an end in themselves. An audit of internal control over financial reporting should not be based on a bottom-up approach starting with financial statement assertions, but should rather commence by determining risks of material misstatements, followed by considering systems and controls to finally result in the accounts and disclosures included in the financial statements of the entity.

In more general terms, the proposed standard should make it clear that careful consideration of the control environment is essential in developing an audit approach. More emphasis should be put on the behavioural types of controls, such as integrity of management, rather than on detailed processes and systems.

The references to financial statement assertions on page 4 in the second paragraph under the section 'Internal Control Over Financial Reporting', in paragraphs 66 to 70 and in Appendix A, Example A-1 in the second part of the scope paragraph on page A-66 are too prominent and misconceived. The guidance related to financial statement assertions in the paragraphs indicated above is also inconsistent with the guidance provided in the first paragraph on page 12 which commences with the design and operating effectiveness of controls.

Moreover, the prominence given to detailed financial statement assertions in the proposed standard and the assertions themselves are not in line with the ISAs which large and medium size audit firms in Europe are committed to follow. Such inconsistency has considerable practical consequences for the adoption of global standards. It also has a profound effect on the audit methodology to be developed by audit firms which will become extremely complex and require considerable investment to redevelop software and retrain staff. Therefore, we urge the Board to revisit the guidance provided in the proposed standard in respect of the prominence given to detailed financial statement assertions.

(f) Controls which do not naturally give rise to documentary evidence

Many important controls over financial reporting do not routinely give rise to documentary evidence. For instance, day to day supervision, coaching and reviewing of staff and their work in the accounting department are sound preventive controls but are ordinarily not documented on a continuing basis.

We fully agree that management should prepare documentary evidence for all significant processes and controls on which the auditor should be able to rely to perform his work in relation to his attestation of management's assessment of the effectiveness of internal control over financial reporting. However, auditors can also, by a process of enquiry and proper evidential corroboration, gain reasonable assurance that other controls exist and work effectively.

Management's responsibilities related to documentation in paragraph 19 are minimal as compared to the detailed requirements for documentation by the auditor in paragraphs 145 to 147. These requirements should be comparable and equally enforceable, as further discussed in our overall comment under (g) below.

The proposed standard indirectly plays down the importance of controls which do not naturally give rise to documentary evidence and incentivises companies to prepare documentation that may not previously have been necessary from a commercial point of view. In contrast, the Sarbanes-Oxley Act does not necessarily require documentation of the effectiveness and operation of controls. We question whether these additional documentation requirements of the proposed standard will provide an increased level of protection for investors commensurate with the increased cost of compliance.

(g) Management acceptance of the PCAOB rules

The Board should not lose sight of the fact that the proposed standard is an auditing standard, compliance with which cannot necessarily be forced upon management of an entity.

Especially where the proposed standard goes further than the Sarbanes-Oxley Act, as highlighted in our response to question 6 and in our overall comment under (f) above, management adherence might be extremely difficult to enforce. In our view the Board has a duty to investors to ensure that its proposed standards for auditors are not made less effective by a lack of corresponding obligations for management.

(h) Divided responsibility

Example A-5 on page A-75 implies that the proposed standard allows for divided responsibility (as distinct from joint responsibility) for auditors in the case of a group audit of consolidated financial statements. While FEE recognises that there are often good reasons to appoint different audit firms to perform the audits of a group of entities, FEE believes that this should not result in divided responsibility for the group auditor. FEE is a long standing opponent of divided responsibility for financial statement audits and strongly favours the auditor of the consolidated financial statements having sole responsibility for his report. The public has to understand who is ultimately responsible for the audit of group financial statements. The same logic applies to opinions on internal control over financial reporting.

(i) Need to reflect IT reality and service organisation auditor guidance

Internal control systems are largely IT driven and are developed not only in-house but also by third parties including service providers.

The guidance in the proposed standard frequently fails to take this IT reality into account and instead provides guidance which appears to be geared toward manual internal control systems. The proposed standard should acknowledge and provide additional guidance reflecting present day reality.

Where an IT driven internal control system is developed by a service provider, this may result in situations where the auditor will not be able to obtain sufficient comfort for his attestation on management's assessment of the effectiveness of internal control over financial reporting because the extensive US guidance on this issue cannot be forced on non US service providers and their auditors. The Board should address such practicalities.

(j) Major concerns about missing guidance for small and medium-sized issuers

The proposed standard indicates that inadequate management documentation of the design of controls and the absence of sufficient documented evidence to support management's assessment of the operating effectiveness of internal control may be a significant deficiency or material weakness or could lead to a scope limitation. This results in additional risks for management and the auditor.

Larger entities might be able to bear and absorb the bureaucratic cost of having documentary evidence for all controls and their effective operation in order for management and the auditor to manage such risks.

Smaller entities typically have a high degree of hands-on, direct management controls which cannot easily be documented. They will also have considerable difficulties to absorb costs of documentation which does not serve a commercial purpose. In these circumstances, management and in particular the auditor will be exposed to greater risk related to the attestation of management's assessment of the effectiveness of internal control over financial reporting.

Therefore, we are in favour of principle-based standards which allow the auditor to use professional judgement. The proposed standard should in this respect include express acknowledgement of small and medium-sized entities by incorporation of the guidance provided in Appendix E within the main text of the proposed standard.

Other overall areas of concern arising from our responses to questions in the PCAOB's Request for Comments

Limited reliance on management and internal control testing: see our response to question 6.

Prohibition on use of periodical testing: see our response to question 11.

Under-emphasis on materiality: see our response to questions 11 and 19.

Problems with definitions: see our response to question 17.

Direct reporting by auditors: see our response to question 26.

Independence issues: see our response to question 29.

Impact of quarterly reporting requirements: see our response to question 30.

Use of professional judgement: see our response to questions 4, 7, 8, 10, 11, 12, 14, 15, 16, 19, 25 and 26.

Response to the questions in the PCAOB's Request for Comments

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?**

   No. It is not appropriate as it is inconsistent with the practice of the IAASB which uses the term 'audit' to refer to the audit of financial statements only. The auditor's attestation of management's assessment of the effectiveness of internal control over financial reporting is an assurance engagement leading to reasonable assurance and not an audit.

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?**

   No. Although it is more efficient for the auditor of the financial statements to perform the attestation of internal control over financial reporting, we favour principle-based standards which require the use of professional judgement and do not include unnecessary prohibitions.

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?**

   Not applicable in view of our response to Question 2.

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, provided that the guidance provided in Appendix E is incorporated within the main text.
   As already noted, we are in favour of principle-based standards which allow the auditor to use professional judgement. Therefore, we believe that the guidance provided in Appendix E is also useful in relation to the work to be performed in a larger entity when it is managed in a similar way to that described in Appendix E.

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.**

   No. Auditing standards should not specify levels of competence and training for specified procedures.

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?**

   Qualified yes. We do not disagree with the proposition that the auditor needs to obtain evidence directly. However, we believe that the proposed requirements for the performance of such procedures by the auditor are excessive.

   Restricting the reliance on management assertions is not acceptable under a principle-based approach. We also believe that some requirements in paragraphs 104 and 105 of the proposed standard are too restrictive and diverge from the requirements of the Sarbanes-Oxley Act.

   More generally, the proposed standard requires the auditor both to evaluate management's assessment and obtain direct evidence about whether the internal control over financial reporting is effective. This goes further than the Sarbanes-Oxley Act, which requires the auditor to report on the assessment made by management.

The proposed standard addresses at length how the auditor should obtain direct evidence of control effectiveness. In contrast, the guidance on evaluating management's assessment process is covered in just seven paragraphs.

We are not convinced that the requirement to obtain direct evidence of effectiveness in all areas of internal controls over financial reporting represents a reasonable use of resources from the point of view of investors, particularly in respect of the testing of control activities. The issuer is already required to carry out its own testing in this regard and those tests should yield the same results as external audit testing.

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

No. Although the suggestions included in paragraphs 43 to 47 might be helpful, the auditor should be allowed to apply professional judgement. It would be helpful to introduce the terms 'might', 'may' and 'could' in the first sentence of paragraph 43.

We also recommend that additional guidance is included to address documentation requirements in the context of the size of the entity and its management structure.

8. (a) Is it appropriate to state that inadequate documentation is an internal control deficiency, the severity of which the auditor should evaluate? (b) Or should inadequate documentation automatically rise to the level of significant deficiency or material weakness in internal control?

(a): Yes as it allows for the use of professional judgement by the auditor.
(b): No.

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

Qualified yes. Walkthroughs are useful to document an understanding of processes and systems, but are not a comprehensive way of testing the effectiveness of controls. We strongly recommend application of the concept of materiality in the context of deciding which systems and processes should be subject to walkthroughs.

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?

No. In the light of using his professional judgement in a principle-based approach, the auditor should be allowed to rely on walkthroughs performed by internal auditors and others, as long as they have been performed using the same high standard as when the auditor would have performed them. We would advise caution before using walkthroughs performed by management, but would not support a prohibition on their use.

11. (a) 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 (b) every year or (c) may the auditor use some of the audit evidence obtained in previous years to support his or her current opinion on management's assessment?

(a): Qualified yes, see detailed comments hereafter.
(b): Qualified yes, see detailed comments hereafter.
(c): Yes.

The basic principle that the auditor should rely on prior knowledge and experience is applicable for every audit and should also be adopted for this type of engagement, under the condition that the auditor only relies on past experience having first satisfactorily updated his prior experience and knowledge by corroborating evidence on the current design and current operation of the controls. In this manner, the auditor can identify where changes have occurred on which he needs to focus.

A requirement to obtain evidence on the effectiveness of controls for every control assertion, for every significant account balance and disclosure, every year is impractical for the auditor and represents a disproportionate use of resources from the point of view of investors as well as disproportionate costs in comparison to the limited benefit for stakeholders.

Again, the auditor should be allowed to use his professional judgement and make materiality judgements.

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

The auditor should never be required to use the work of management and others, but should be permitted to do so using his good professional judgement. The extent to which the auditor should be allowed to do so is further detailed in the response to Question 13 below.

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

No. We are sceptical about the practical application of such a rule-based approach to categorisation of controls. We prefer a principle based approach whereby a range from high level, management driven controls to low level routine controls is used to determine the acceptable level of reliance for the auditor. Control categorisation is not required as the determining factor is the integrity and good faith of management, internal audit and others upon whom the auditors may rely.

14. Does the proposed standard give appropriate recognition to the work of the internal auditors? If not, does the proposed standard place too much emphasis and preference on the work of internal auditors or not enough?

Qualified yes. The guidance provided in paragraph 108 is acceptable if the categorisation as described in Question 13 is abolished. Internal auditors should be able to perform work classified as (1) in the categories referred to in Question 13 and external auditors should be able to rely on such work based on their professional judgement.

15. (a) Is the flexibility in determining the extent of reperformance of the work of others appropriate, or (b) 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)?

(a): Yes.
(b): No.

The auditor should use his professional judgement to determine whether it is appropriate to rely on the work of others.

We refer to our response to Question 6 for further details.

16. **Is the requirement for the auditor to obtain the principal 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?**

    No. Again, the auditor should have the overall responsibility to decide which sources of evidence to rely on by using his professional judgement to determine whether it is appropriate to rely on the work of others or whether there is a need to obtain evidence through his or her own work.

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?**

    The answer is 'no', although it is not clear what the basis for comparison is supposed to be. The definitions of 'material', 'significant', 'remote' and 'inconsequential' are not in line with the definitions included in the ISAs or are not included in the ISAs which will be adopted in the European Union from 2005. Additionally, the meaning of the term 'remote likelihood' as used in the definitions of 'significant deficiency' and 'material weakness" will mean that very little will not need to be reported as a finding in the auditor' attestation of management's assessment of the effectiveness of internal control over financial reporting. Therefore, we prefer the continued use of the definitions included in Statement on Auditing Standards ('SAS') No. 60.

18. **(a) Do the examples in Appendix D of how to apply these definitions in various scenarios provide helpful guidance? (b) Are there other specific examples that commenters could suggest that would provide further interpretive help?**

    (a): No, taking into account our response to Question 17;
    (b): No.

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

    Yes. However, it would be helpful to define the term 'evaluate'; we understand it to mean that the auditor is allowed to use his professional judgement and make materiality judgements, including judgments on the documentation of the 'evaluation'.

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. However, one would expect that, as a result of the audit of the financial statements, all internal control deficiencies would already have been communicated to management in writing under the form of a 'management letter' in accordance with existing professional standards. Such a process should not be duplicated and there is no need for a new standard on this topic.

    We also refer to our overall comment on 'two audits' detailed under item (c).

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

    Yes, they are acceptable as risk indicators.

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, but some issues resulting from the inherent "conflict of interest" between the audit committee and the auditor need to be addressed as the audit committee is expected to supervise the work performed by the external auditor. In accordance with the principle-based "threats and safeguards" approach reflected in the IFAC Ethics Code, the auditor could for example request an independent colleague ("review partner") to assist him.

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

Yes, taking into account the considerations indicated in our response to question 22.

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 the auditor should be allowed to use his professional judgment. Also, this would not be possible in certain European countries where a statutory auditor is appointed for a certain period of time.

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?

No. We do not believe that a material weakness should automatically result in an adverse opinion from the auditor. The auditor should be allowed to use his professional judgement to determine whether a material weakness merits a qualified rather than an adverse opinion.

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

Yes. Consistent with the possibility for the auditor to decide to issue a qualified rather than an adverse audit opinion on financial statements, the auditor should be able to use his or her professional judgement to determine the type of opinion to issue in respect of the auditor's attestation of management's assessment of the effectiveness of internal control over financial reporting.

More generally, we note that the proposed unqualified opinion refers to management's assessment process, and offers no view on the effectiveness of internal controls. However, an adverse opinion requires the auditor to opine on the (in)effectiveness of internal control without mention of management's assessment process. We would have expected these two opposite types of auditor's opinion to be a mirror image of each other. Unfortunately this is not the case. Direct reporting by the auditor in respect of ineffective internal controls will not assist the reader in understanding the auditor's attestation.

Further confusion arises in Example A-6 where the auditor issues an unqualified opinion that refers to the report of other auditors. There the example opinion provides a view on the effectiveness of controls, but not on management's assessment process.

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 internal control over financial reporting rather than to whether management's assessment is fairly stated?

No. We refer to our response to Question 26.

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

No, other existing standards address such issues at length. See our response to Question 29 below.

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

Yes. Although we favour principle-based standards which rarely include prohibitions, we believe that it is appropriate to limit the performance of certain internal control-related non-audit services by the auditor of the financial statements. No additional guidance is required in this respect as the SEC independence rules deal with this topic in sufficient detail.

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, but not applicable in the European Union. There is no SEC requirement for foreign registrants to have the auditor perform and report on quarterly work, whether related to the financial statement audit or to the attestation of management's assessment of the effectiveness of internal control over financial reporting. The Sarbanes-Oxley Act (Section 302) requires management to report quarterly on internal control. However, no auditor's attestation is required on a quarterly basis.

Where quarterly work is performed by the auditor, the auditor should have a different level of responsibility for management's quarterly interim certifications.

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

Yes, but not applicable for foreign registrants in the European Union. We refer to our response to Question 30 above.

If you have any further questions about our views on these matters, do not hesitate to contact us.

Yours sincerely,

David Devlin
President

financial executives international

November 20, 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

Ladies and Gentlemen:

The Committee on Corporate Reporting ("CCR") of Financial Executives International ("FEI") would like to thank you for this opportunity to comment on the Public Company Accounting Oversight Board's ("the Board") proposed auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("the proposed standard"). FEI is a leading international organization of 15,000 members, including Chief Financial Officers, Controllers, Treasurers, Tax Executives and other senior financial executives. CCR is a technical committee of FEI, which reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. This document represents the views of CCR and not necessarily those of FEI.

CCR would like to recognize the Board members and staff for their diligent work in preparing this proposal. FEI has long been a supporter of management's responsibility for creating and maintaining an effective control environment. We take this responsibility seriously and believe that the management certification process alone will significantly improve the strength of internal control. While we acknowledge that an external review of management's assessment will provide additional assurances, we believe the proposed standard requires the auditor to perform attestation procedures that are not only beyond the scope of Sections 103 and 404 of the Sarbanes-Oxley Act ("the Act"), but will provide questionable additional benefit to financial statement users at a high financial and time-consuming cost.

In summary, we are pleased that the proposed standard appears to have incorporated some of the views previously expressed by CCR. Additionally, we would agree that from a high level, the proposed standard seems to represent a balanced approach. However, we have significant concerns on several sections of the proposed standard and we believe that if it is implemented in its current state, the level of duplicative testing and the resulting impact on business operations will result in unnecessary costs to investors in public companies that are far beyond the benefits expected.

Specific responses to the Board's questions on the proposed standard are included in Attachment A. In addition to these responses, we respectfully submit the following general observations for the Board's consideration:

- We believe that the standard as currently drafted creates a situation where the costs far outweigh the benefits of implementation. Given the limited level of reliance that the external auditor can place on the work of others (as discussed further below), the resultant level of duplicative testing will cause numerous interruptions to the operations of our businesses. These interruptions alone are very costly; however, when coupled with the cost of internal and external resources to support management's assertion and the fees associated with the increased work to be performed by the external auditor, the costs are far beyond the benefits attained. Most CCR companies estimate an increase of approximately 30% to 50% in audit fees as a direct result of the required audit of internal control over financial reporting. Most would not mind the cost if we believed that the work being done would really improve controls or prevent future corporate scandals similar to those experienced over the past few years. We believe the work required by the final standard should be focused on the significant issues such as business risk and fraud prevention and detection.

- We believe that management's assertion of internal control effectiveness must be thoroughly supported by annual testing. However, we do not agree that the auditor's review must be equally thorough, annually. Given that the Act requires the auditor to evaluate management's process and assertion, we do not believe the auditor must independently evaluate all controls annually, but rather should rotate its efforts in assessing management's process. This rotation will prove cost efficient and support user's interests.

- We also believe that the proposed standard does not allow the auditor to exercise sufficient judgment and in particular, use as a basis, prior audit experience with their clients. The proposed standard is prescriptive, causing auditors to perform the same level of testing at companies with strong control structures as would be performed at those with weak control structures. For example, in the area of appropriate levels of testing, we believe that the proposed standard should grant the auditor more latitude on testing strategies and rotating tests of controls, dependent upon the auditor's evaluation of the overall control environment of the organization. Specifically, in situations where the control environment is very strong, the level of detail testing of the controls over routine data processing should be permitted to be minimal, or in such situations where processes remain unchanged, the auditor should be able to use his or her judgment in determining what level of testing would be appropriate (e.g., rotation or obtain an update of their understanding followed by a walkthrough of the process). Further, we are concerned that the proposed standard has been too prescriptive in requiring the auditor to evaluate ***all*** controls addressing the risk of fraud. The auditor should be able to exercise judgment in this area as well.

- The Board's three-tiered approach to reliance on the work of others, while intending to be helpful, has the effect of allowing very little reliance on the work of others or restricting such reliance to only routine transaction processing. Specifically, we do not believe the Board has adequately supported its proposed requirements with respect to the auditor's required evaluation of IT general controls and the financial statement closing process with no reliance upon internal audit or management's procedures. These are pervasive areas that will lead to significant levels of repetitive, detailed testing by numerous parties if the proposed standard is adopted.

- As stated above, we believe that the proposed standard places very little value on the work of a company's management and its internal auditors. In doing so, the standard requires that the external auditors reperform a significant level of testing for which the results of identical testing are easily obtainable from management. We would like the Board to recognize that many management groups have significant financial reporting controls expertise and operate within strong internal control structures. High quality management work should limit the scope of required testing by both internal and external audit. Further, we would like the Board to be more flexible in terms of how much reliance the external auditor can place on the work of both management and the internal audit function. As drafted, the proposed standard seems to equate management testing with that of internal auditors. A properly functioning internal audit function is competent, objective and independent from management. As such, the proposed standard should allow for a significant amount of reliance on the work performed by internal auditors, especially in areas beyond routine transaction processing. Moreover, the work of an internal audit function adds accountability to a company's control structure, which in turns causes the control execution to be more consistent.

  The relationship of the internal audit function to the external audit of financial statements is already addressed in detail within the Statement of Auditing Standards. No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* ("SAS 65"). CCR believes that the relationship defined in SAS 65 is appropriate and does not need to be redefined. Rather, the Board's standard should utilize the provisions of SAS 65 to determine the minimal additional audit steps to evaluate internal control over financial reporting. Further, CCR is concerned that if unchanged, the apparent diminished recognition of internal audit's vital role could eventually lead to decreased reliance on the internal audit function as it relates to the audit of the financial statements. We believe this diminished recognition of the internal audit function is not intended by, and is contrary to, the SEC's ruling under Section 404 of the Act.

- We believe that the proposed standard should expand on the requirements for the auditor to execute a walkthrough. In doing so, the standard should explicitly state when and where a walkthrough is needed. We believe walkthroughs are only one method in which to achieve audit evidence and, therefore, should not be mandated for every significant process. Further, most routine processes lend themselves easily to walkthroughs, whereas other processes that are non-routine and involve a significant amount of judgment do not. To that end, a more detailed explanation of what constitutes a walkthrough in such circumstances would be helpful. Again, this is an area where the auditor should be able to exercise significant judgment.

- We agree philosophically that effective oversight by the audit committee is an important component of the control environment. However, we do not believe that the auditor is in an objective position to evaluate the audit committee. Considering that the audit committee makes the decisions regarding hiring and firing of the external auditors, such an evaluation would put the auditor in an awkward position. This position could cause the auditor to be unwilling to conclude that the committee is ineffective. Further, and perhaps more importantly, we believe that a properly functioning audit committee is comprised of individuals with a much broader expertise than that held by the professional auditor. Accordingly, we do not respectfully believe that most external auditors carry the level of expertise necessary to effectively evaluate an audit committee.

- We would like to commend the Board for their conclusions that only material weaknesses be reported publicly. However, the proposed standard should be more explicit in defining how a deficiency elevates to a significant deficiency and a significant deficiency to a material weakness. We believe the Board should further define or clarify what the term "inconsequential" means as it relates to the definition of a significant deficiency. Further, we believe that internal control over financial reporting is a network of controls with multiple levels. To this point, the standard should require the auditor to evaluate the presence of other compensating controls that would prevent a misstatement of the financial information. We are concerned that the examples outlined in Appendix D of the proposed standard are too narrow and do not appropriately consider materiality. These examples only focus on the first layer of controls, rather than considering the entire structure as a whole. We believe that in most organizations, there would likely be other mitigating or compensating controls in place to detect material misstatements. We believe that examples of compensating controls that keep a deficiency from elevating would be helpful.

We truly appreciate the opportunity to comment on the Board's proposed standard and the Board's consideration of our concerns. Moreover, we welcome the opportunity to discuss these issues at your convenience. Finally, we would like to encourage the Board to issue the final standard as expeditiously as possible, especially considering the significant time constraints for our June 30, 2004 filers. If you have questions regarding this letter, please feel free to contact Frank Brod at (989) 636-1541 or Kate Asbeck at (607) 974-8242.

Sincerely,

Frank Brod
Chair, Committee on Corporate Reporting
Financial Executives International

Kate Asbeck
Chair, PCAOB Subcommittee
Committee on Corporate Reporting
Financial Executives International

Attachment A
Responses to Specific Questions

Questions regarding an integrated audit of the financial statements and internal control over financial reporting:

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?*

    Yes, we believe it is appropriate to refer to the auditor's attestation as the audit of internal control 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?*

    Yes, we believe an audit of internal control over financial reporting should be integrated with an audit of the financial statements and therefore, the same auditor should perform both audits.

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?*

    As stated in the response to question two above, we believe that the same auditor should perform both the audit of the financial statements as well as the audit of internal control over financial reporting.

Question regarding the costs and benefits of internal control:

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?*

    We believe the standard should further explain the importance of the control environment (i.e., financial leadership with a high level of integrity, etc.) as it relates to the impact of the testing and documentation requirements of the proposed standard. In small to medium sized companies, the senior financial leadership is much closer to the operations of the entity and, as such, various levels of control are not as necessary.

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.*

   No, we believe the Board should leave it to the audit firm to determine the professional competencies and training necessary to execute the attestation in accordance with the Standard's framework. The Board, however, should encourage audit firms to include COSO and other internal controls training in their curriculums. Similar to an audit of financial statements, it is important for the auditors to have the business context and industry perspective for that particular engagement in order to perform an internal controls evaluation effectively.

<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?*

   CCR would like to reiterate its position that the auditor should be evaluating management's process in arriving at management's assertion, rather than performing a duplicative level of testing to support the auditor's own conclusions. We respectfully disagree with the Board's interpretation of Section 103 (a) (2) (A) (iii) of the Act, that the auditor must be able to agree that internal controls are operating effectively, rather that they are designed effectively. Therefore, we do not believe the scope of the audit of internal control over financial reporting is appropriate.

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

   We believe that guidance for the auditor is appropriate; however, we also believe that the standard should leave room for the auditor's professional judgment in evaluating the adequacy of the documentation.

8. *Is it appropriate to state that inadequate documentation is an internal control deficiency, the severity of which the auditor should evaluate? Or should inadequate documentation automatically rise to the level of significant deficiency or material weakness in internal control?*

   We believe that the standard should allow for the auditor to exercise judgment around the appropriate level of documentation of internal control over financial reporting. We do not believe that a "one size fits all" approach is appropriate in this case. Many different factors, such as size and complexity of the organization, compensating controls and senior management tone over the control environment should influence the level of documentation necessary. Furthermore, we believe that inadequate documentation is ***at most*** a deficiency, as a lack of documentation alone will not lead to any misstatement of financial information. It is the lack of actual controls, not the documentation of the controls, which may lead to misstatements.

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?*

We believe that, for routine processes with high transaction volumes, a walkthrough of the process is an important procedure. However, as mentioned in the body of our letter, there are numerous processes that will not lend themselves easily to walkthroughs. Accordingly, a blanket requirement for walkthroughs of all significant processes may not achieve the desired objectives. Again, we believe the auditor should have the flexibility to exercise judgment about the appropriate procedures to be performed for specific accounts and assertions. Review of management's policies and procedures, interviews with personnel and transaction reviews are other methods that can be used to meet this same objective.

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?*

We believe the Proposed Standard should allow for more auditor judgment in determining what types of work the auditor can rely upon to support their attestation report. It is not clear why the Board believes such procedures can only be performed by the auditors in all cases and challenge whether work performed (and documented) by others would not meet the same objective.

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?*

We believe that in many organizations, the controls are substantially unchanged from year to year. In such circumstances, the auditor should be able to utilize his or her cumulative audit knowledge and judgment in determining the appropriate level of testing. In a well-controlled environment, an update of the auditor's understanding along with minimal testing should be appropriate.

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?*

    As outlined in the body of our letter and in response to question 10 above, we believe that the Board has not fully recognized the competence and objectivity of most internal audit functions. The practice of utilizing the work of the internal auditor should be permitted to a much greater extent than currently considered in the proposed standard. Furthermore, in certain routine processing, the auditor should be able to use the work of management, obviously to a lesser degree than that of an internal auditor, but still to a substantial degree.

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

    We believe that the categories of controls are appropriate. However, we would argue that the examples of what is categorized into each section are too restrictive. For instance, the auditor should be able to rely heavily on the walkthroughs performed by others, the work of an internal audit specialist and, in some cases, management, on IT general controls, and the work of others on the routine portions of the financial statement close process.

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?*

    As previously stated in the body of the letter and in response to question numbers 10 and 12 above, the standard does not give appropriate recognition to the work of the internal auditors. Further, the Board has seemed to equate the work of management and the work of the internal auditor. As stated before, in a properly functioning internal audit system, the internal audit function is both independent and objective. The determination as to what level of reliance the auditor can place on the work of the internal auditor is already addressed in SAS 65 for audits of financial statements and should be no different in the audit of internal control over financial reporting. To reiterate, this standard ***does not place enough emphasis*** on relying on the work of the internal auditor.

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)?*

    We believe that the standard should allow for auditor judgment in determining the extent of reperformance necessary.

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?*

    We do not believe this requirement is appropriate. We caveat this response by reiterating our previous point that we believe the auditor's responsibility under Section 404 of the Act is to evaluate management's process in arriving at their conclusions as to the effectiveness of internal control over financial reporting. If this requirement remains in the final standard, we encourage the Board to provide a more robust explanation of what is meant by "principal evidence".

Questions regarding evaluating results:

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?*

    We believe that the definitions in the proposed standard are appropriate. However, we also believe that the standard should outline the considerations of other controls within the control structure that could prevent a deficiency from becoming a significant deficiency, and a significant deficiency from becoming a material weakness. Additionally, we believe the introduction of the new term "inconsequential" in the description of a significant deficiency has created unnecessary ambiguity. Instead, the auditor should have the responsibility to exercise his or her professional judgment in determining those deficiencies to be reported to the audit committee.

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?*

    As discussed in the body of our letter, we believe that the examples in Appendix D should be expanded to further explain situations where controls in place would keep a deficiency from elevating to the next level. Furthermore, the examples of significant deficiencies include an ineffective risk assessment and regulatory compliance functions. These appear to extend beyond the scope of financial reporting.

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

    We agree that it is important for the auditor to evaluate all identified deficiencies.

20. *Is it appropriate to require the auditor to communicate all internal control deficiencies (not just material weaknesses and significant deficiencies) to management in writing?*

We believe that the standard should allow for auditor judgment in determining which deficiencies should be reported to management. The auditor does not report all findings in a financial statement audit, especially findings of insignificant value. Accordingly, using the same logic, the auditor should not be required to report ***all*** deficiencies to management. Such required reporting would likely carry a cost that is beyond the benefits gained.

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

We do not disagree with most of the indicators mentioned in the proposed standard. However, considering that both Section 404 of the Act and the proposed standard focus on the internal control over financial reporting and not on the controls related to compliance with laws and regulations and controls related to efficiency of operations, the indicator related to ineffective regulatory compliance seems out of scope with the Act.

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?*

We do not disagree philosophically with the notion that effective oversight by the audit committee is an important component of the control environment. However, we do not believe that the auditor is in an objective position to evaluate the audit committee. This is primarily due to the fact that the audit committee has the responsibility for hiring and firing the external auditor.

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

As discussed in our response to question number 22, we do not believe that the auditor is in an objective position to evaluate the audit committee as a result of the fact that the audit committee has the responsibility for hiring and firing the external auditor.

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?*

We do not believe that this would be an appropriate response.

<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?*

We believe that this requirement is appropriate only if the material weakness has not been corrected prior to the "as of" date in management's assessment.

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

We believe that, in certain circumstances, an "except for" conclusion may be appropriate. Such circumstances may include an acquisition completed within a short timeframe of a fiscal year end.

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?*

We believe that the standard should require the reports to be consistently directed either at management's assessment of internal control over financial reporting or the internal control over financial reporting itself.

<u>Questions regarding auditor independence:</u>

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

We believe that all parties would benefit from additional guidance in this area.

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

We believe that the external auditor should be prohibited from performing any significant work that assists management in arriving at its assessment of the internal control over financial reporting.

<u>Questions regarding auditor's responsibilities with regard to management's certifications:</u>

30. *Are the auditor's differing levels of responsibility as they relate to management's quarterly certifications versus the annual (fourth quarter) certification, appropriate?*

We believe that the differing levels of responsibility are appropriate in this case. The auditor's quarterly requirements should be limited to inquiry only and focused very heavily on negative assurance.

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

We agree with the scope of the auditor's responsibility for quarterly disclosures about the internal control over financial reporting.

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")

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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

Office of the Secretary
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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]

[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. <u>Discretion Should Be Permitted as to the Extent of Control Testing.</u>

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. <u>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.</u>

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
Securities Industry Association

[FCFC Letterhead]

November 21, 2003

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re*: PCAOB Rulemaking Docket Matter No. 008*

Dear Board Members:

We appreciate the opportunity to comment on the Proposed Auditing Standard: *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*, issued on October 7, 2003 ("Proposal"). First Commonwealth Financial Corporation is a $5 billion NYSE listed financial institution headquartered in Indiana, Pennsylvania. First Commonwealth is particularly interested in this proposal since, not only are we an issuer of financial statements, but as a financial institution we are members of one of the largest users of financial statements, being creditors.

The Proposal indicates, "an attestation, in a general sense, is an expert's communication of a conclusion about the reliability of someone else's assertion." This acknowledges that someone else has the primary responsibility for the assertion, in this case, for the adequacy of the internal controls over financial reporting. We believe that the Proposal places an undue burden on the certifying auditor. The auditor has little ability to rely on the competency and thoroughness of the organization's management and internal audit process. Specifically, the burden for independent auditors to directly test the items listed in paragraph 104, such as the **controls that are part of the control environment, controls over the period-end financial reporting process, information technology controls and walkthroughs,** appears to infer that there is no reliability to any work performed by management or its internal auditors. We believe that in order to achieve a reasonable assurance on the existence and effectiveness of the controls, walkthroughs and testing performed by others utilizing the International Standards for the Professional Practice of Internal Auditing issued by the Institute of Internal Auditors, or similar standards, could be relied upon. This is especially true for the companies where its internal audit department reports directly to the Audit Committee that is comprised entirely of independent directors, as defined by the respective listing standards.

The Proposal also requires a high level of documentation of the controls in itself to be a control of such importance that, if not adequate, could be a significant deficiency or material weakness. We feel, that while the lack of documentation could indicate that controls are not present, in reality controls could exist. Therefore, if alternative audit procedures are performed, the existence of the controls could be substantiated and the lack of documentation should not be classified as a significant deficiency.

In conclusion, we feel that the Proposal attempts increase the level of assurance to “absolute”. Indications are that our external auditor costs to comply with this Proposal will increase significantly. Internal costs will also increase. We feel that the additional cost to provide a greater level of assurance is higher than the expected benefits.

Again, we appreciate the opportunity to comment on this proposal. Thank you for considering our views. For further discussion of this matter, you may contact John Dolan at (724) 464-1106 or Leonard Lombardi at (724) 463- 4703, or at the address above.

Sincerely,

/s/ John J. Dolan
John J. Dolan
Executive Vice President and Chief Financial Officer

/s/ Leonard V. Lombardi
Leonard V. Lombardi
Sr. Vice President, Internal Audit

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November 21, 2003

Office of the Secretary,
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Re: PCAOB RULEMARKING DOCKET MATTER NO. 008
Proposed Auditing Standard--An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

The Accounting Principles and Auditing Standards Committee of the Florida Institute of Certified Public Accountants (the Committee) has reviewed and discussed the above referenced proposed auditing standard. As requested in the proposal, the Committee is responding to the thirty-one questions contained therein.

Question 1: The Committee had no issue with this language.

Question 2: The Committee felt that the auditor **should be prohibited** from performing an audit of internal control without also performing an audit of the financial statements. The Committee felt that the auditor should do both; that the functions are integrated.

Question 3: Requiring the auditor to perform comparable work would **not** be appropriate. This would be confusing to the reader of the statements. A complete audit should be performed.

Question 4: The Committee believes that the needs of small and medium-sized issuers have been adequately considered. The Committee noted that given the wide diversity of small and medium-sized issuers more specific direction would be difficult to disseminate and the Board is correct to rely on the auditor's professional judgment.

Question 5: The existing professional literature clearly specifies that audits are to be performed by persons having adequate training and proficiency and those assistants are to be properly supervised. Therefore, the Board does not need to specify the level of competency and training of audit personnel.

Question 6: Yes, the scope seems appropriate. The auditor cannot evaluate management's assessment without obtaining supporting evidence.

Question 7: The Committee was divided on this issue. Approximately six of the members felt that the Board should be providing guidance and a framework to the auditor so that the auditor would be able to exercise professional judgment in assessing whether management's documentation provided reasonable support for it's assessment.

The remaining six members thought that criteria was appropriate but did not agree with listing specific items that met the requirement of adequate documentation paragraph 43 of the proposed standard. Instead the standard may address the issue of determining whether management's documentation provides reasonable support for its assessment by stating something like: "When determining whether management's documentation provides reasonable support for its assessment, the auditor should evaluate whether such documentation exists to support the auditor's opinion on internal controls over financial reporting".

The entire Committee felt that the "checklist" approach was not appropriate because it encourages preparers to focus only on the listed items. The bullet points following paragraph 43 might be better presented in an appendix as an example of points that management should include in its documentation of its assessment of internal controls

Question 8: The Committee agreed that the auditor **should** be the one to evaluate the severity of inadequate documentation and further, that the inadequacy should **not** automatically rise to some arbitrary level; the auditor should use professional judgment to determine whether the deficiency gives rise to a significant deficiency or a material weakness in internal control.

Question 9: The Committee agrees that walkthroughs should be performed. However, the Committee is concerned about the language in paragraph 79, which states that "the auditor should trace ALL types of transactions...both recurring and UNUSUAL". The Board should provide guidance on what they mean by "ALL" and "UNUSUAL". The Committee believes it is not reasonable to require auditors to trace ALL types of transactions, rather to focus on significant areas. The Committee noted that one might be dealing with an insignificant unusual transaction within a significant process that actually did not need a walkthrough.

Question 10: The Committee agreed that the auditor should do the walkthrough so that a thorough understanding of the internal control process is obtained.

Question 11: The Committee believes that it is appropriate for the auditor to use some of the audit evidence obtained in previous years to support his or her current opinion on management's assessment.

Question 12: The Committee believes that the auditor should be permitted (not required) to use the work of others. The auditor should rely on professional judgment.

Question 13: The Committee feels that the definition of the three categories of controls and the extent to which the auditor may rely on the work of others is appropriate and is consistent with existing professional literature.

Question 14: The proposed standard acknowledges the professional status and work of the internal auditor. The auditor's reliance on their work is a matter of professional judgment depending on whom the internal audit function reports to and what level of standards they enforce.

Question 15: The Committee believes that the flexibility allowed in the proposed standard is appropriate which is that the auditor should use professional judgment to determine the extent of any re-performance.

Question 16: The Committee agrees that the auditor should obtain the principal evidence through his or her own work.

Question 17: The Committee felt that the Board should provide definitions of "inconsequential in amount" and "material misstatement" used in the summary paragraph at the end of page 15 and the top of page 16. There seems to be a great deal of latitude between those concepts.

Question 18: The Committee agrees that the scenarios in Appendix D are helpful. They would like to see more examples of internal control deficiencies.

Question 19: The Committee believes that the auditor should evaluate the severity of all identified internal control deficiencies.

Question 20: The Committee was somewhat divided on this issue. Many felt that some internal control deficiencies are so minor that they can be handled in verbal communication; however, the entire Committee agreed that documentation of the communication, at least in the workpapers, should be required.

Question 21, 22, & 23: The Committee felt very strongly that the auditor could **not** evaluate the audit committee's *effectiveness*. Effectiveness cannot be measured. Thus, the Committee feels that the proposed standard would be more appropriate if it required the auditor to "consider" whether the audit committee is appropriately addressing and monitoring relevant issues in a timely fashion and on a consistent basis.

The Committee agreed that the indicators of material weakness were appropriately classified but would eliminate the term "ineffective" from the third bullet point in paragraph 126.

Question 24: No, the standard should not require the auditor to withdraw from the engagement. First, ineffective audit committee oversight does not necessarily result in financial statements that are unfairly presented or not in accordance with GAAP. Second, withdrawal will not solve the company problem; working with the audit committee to improve their performance would better serve the interests of shareholders.

Question 25: The Committee agreed with the proposed standard that the existence of a material weakness that requires the auditors to express an adverse conclusion is consistent with the reporting model for management.

Question 26: The Committee believes that there are circumstances where a qualified "except for" conclusion would be appropriate. For example, suppose that management asserts that their internal controls are operating correctly and the auditor finds some small deviation which could be minor and it is effectively mitigated by other controls. The auditor should be able to mention the exception without having to give an adverse opinion.

Question 27: The Committee strongly agrees with the proposed standard's position.

Question 28: The Committee believes that specific guidance should be provided. It would be helpful to include examples of such actions in the standard.

Question 29: All internal control-related non-audit services should be prohibited; otherwise, the auditor is monitoring his own work.

Question 30 & 31: The Committee agrees with the proposed standard.

ADDITIONAL ITEMS FOR CONSIDERATION:

The Committee also wanted clarification regarding the reference to "COSO" in the introductory paragraph in the example Auditor's Report in Appendix A. What other criteria would be appropriate? What criteria would be appropriate for small and medium-sized firms?

The Committee appreciates the opportunity to share our views and concerns. Members of the Committee are available to discuss any questions you may have regarding this communication.

Very truly yours,

Lizette Pena, CPA, Chair

Committee members coordinating this response:
Kathryn M. Means, CPA, Vice-Chair
Joel S. Baum, CPA

James C. Gouin
Vice President and
Controller

One American Road
Dearborn, Michigan 48126

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

Ladies and Gentlemen:

Ford Motor Company ("Ford") is pleased to respond to PCAOB Release No. 2003-017 (the "proposing release") concerning proposed auditing standards for audits of issuers' internal control over financial reporting. We have comments in regard to three specific aspects of the proposing release: the definition of significant deficiency, reliance on the work of internal auditors and other control related activities, and the auditor's assessment of the issuer's audit committee.

Definition of Significant Deficiency

In regard to the proposed changes in the criteria that would be used in determining if an internal control deficiency is a "significant deficiency", addressed in paragraph 8, we believe that the present guidance set forth in Statement of Accounting Standards No. 78 for determining a significant deficiency is appropriate and should be retained for the proposed auditing standards. We note that the Securities and Exchange Commission (the "Commission"), in promulgating its rules under Section 404 of the Sarbanes-Oxley Act of 2002, did not change the SAS No. 78 standards.

The proposed criteria of "more than an inconsequential amount" for determining a significant deficiency could result in the auditor and company management focusing on issues of relatively small value that are not important to the overall effectiveness of a company's internal controls over financial reporting. This could result in inefficient use of the time and resources of the auditor, company management and its audit committee. It also could result in misleading or incorrect views of a company's internal controls over financial reporting by external parties. We do not believe that "more than inconsequential" is an appropriate threshold for determination of a significant deficiency.

As stated above, we believe the present guidance in SAS No. 78 for determining a significant deficiency is appropriate and should be retained.

Reliance on Work of Internal Auditors and Other Control Related Activities

We believe the proposing release unduly limits the reliance that external auditors can place on the work of a company's internal audit and other control related activities. We believe there is more "duplicative" audit work by the external auditors than is necessary as a result of "walkthrough", control environment, and IT testing requirements, as well as the requirement that on an overall basis the external auditor's own work must provide the principal evidence of effectiveness. The external auditors should be able to balance external objectivity with internal expertise in an effort to maximize the quality and minimize the cost of the audit requirements. This could be accomplished by allowing a more risk-based audit approach in conjunction with the flexibility to rely more on the internal audit/control work performed by a company.

Qualifications of Audit Committee Members in the Context of a Public Subsidiary

We note that paragraphs 56 through 59 address the auditor's assessment of the effectiveness of an issuer's audit committee in overseeing the issuer's external financial reporting process and internal control over financial reporting. In particular, we note that the independence of the audit committee members is one of the seven factors listed that an auditor should evaluate in assessing the audit committee's effectiveness.

Although it is not clear in the proposing release, we assume that, with respect to a public entity that is a subsidiary of a parent that itself is a public company, the standards set forth in the proposing release for assessing audit committee effectiveness are intended to relate to the parent company's audit committee and not the subsidiary's audit committee.

Included in Ford's consolidated financial statements are the financial results and condition of Ford Motor Credit Company ("Ford Credit") and The Hertz Corporation ("Hertz"), both of which are indirect, wholly-owned subsidiaries of Ford. Each of Ford Credit and Hertz is subject to the periodic reporting requirements of the Securities Exchange Act of 1934, as amended, by virtue of having outstanding debt securities, the issuance of which has been registered under the Securities Act of 1933, as amended. Neither Ford Credit nor Hertz has an audit committee comprised solely of members that are independent of Ford or itself.

In adopting rules under Section 301 of the Sarbanes-Oxley Act of 2002 concerning listed company audit committee standards, the Commission addressed the issue of audit committee independence in the context of public subsidiaries of public parents by specifically exempting direct or indirect consolidated subsidiaries that have listed securities from the requirements (including the independence requirements) of the rules if their listed parent companies were subject to the rules. In the adopting release (SEC Release Nos. 33-8220 and 34-47654), the Commission stated:

> Requiring these subsidiaries, which often have no purpose other than to issue or guarantee the securities, to be subject to the audit committee requirements would add little additional benefit if the subsidiary is closely controlled or consolidated by a parent issuer that is subject to the requirements. Instead, imposing the requirements on these subsidiaries could create an onerous burden on the parent to recruit and maintain an audit committee meeting the requirements for each specific subsidiary.

We assume the PCAOB did not intend in the proposing release to vitiate the exemption for listed or public subsidiaries provided in the Section 301 rules. We, therefore, urge the PCAOB to make it clear in paragraphs 56 through 59 that in the context of a public subsidiary whose parent is also a public company, the standards for assessing the effectiveness of an audit committee are to be applied to the parent company's audit committee.

Should you have any questions or comments, please feel free to contact me by telephone at 313-323-6901.

Sincerely,

/s/ James C. Gouin

James C. Gouin
Vice President and
Controller

cc: Mr. Alan L. Beller, Director
Division of Corporation Finance
U.S. Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

From: seetheforrestnotthetrees@rcn.com
Sent: Friday, November 21, 2003 4:54 PM
To: Comments
Subject: PCAOB Rulemaking Docket Matter No. 008

Distinguished Board Members,

When Chairman McDonough kicked-off the July 29th roundtable discussion on the reporting of internal control that preceded the proposed audit standard he said "In my view, good internal controls are cost effective, and once put in place more than justify the expense involved" – a statement with which I strongly concur.

However, I do not agree with the proposed standard since it requires the external auditor to perform significant audit work without adequate consideration of the additional costs and benefits involved. The roundtable discussion lacked sufficient debate on this point.

In fact there was even a suggestion to the board that "the cost benefit analysis really isn't the right way to look at things". Since I do not see an analysis of the relevant costs and benefits of the proposed audit standard (versus the cost and benefit of internal controls themselves which was discussed), the Board appears to have taken this suggestion to heart. In my opinion, the failure to acknowledge the basic fact that resources always have constraints has resulted in an unbalanced standard, despite the clear intention of the Board to contrary.

I respectively suggest that the Board analyze and give serious consideration to the expected costs and benefits of implementing any final standard. Without this type of analysis, there is a high risk that the standard could have unintended consequences.

For example, rather than being seen as an effective tool of management, internal control could be seen "as a necessary burden, imposed by regulators or by the dictates of overzealous bureaucrats" (COSO report page 14).

Another unintended consequence of setting the attestation bar too high could be the addition of controls based on the suggestion of conservative or inexperienced external auditors. A recent article describes how a big 4 accounting firm was looking to borrow twenty auditors from its sister operation in South Africa to deal with the increased workload. This is a natural response to a proposed standard that self proclaims that the audit of internal control over financial reporting "is an extensive process". The second Generally Accepted Auditing Standard related to field work already requires the auditor to obtain a sufficient understanding of internal controls. This standard clearly takes into account the cost benefit aspect and is used by the auditor to determine how much substantive work is to be performed. Were recent audit failures caused by deficient audit standards, or deficient audits?

A final unintended consequence to consider is a widening of the expectation gap. In your Release No. 2003-017 you state that "regardless of how well any system of internal control over financial reporting is designed and operating, it cannot provide absolute assurance of achieving financial reporting objectives because of inherent limitations. These inherent limitations exist because internal control over financial reporting is a process that involves human diligence and compliance and, consequently, can be intentionally circumvented." Likewise, COSO points out that "internal control sometimes is looked upon as a cure-all for all real and potential business ills. This view is misguided. Internal Control is not a panacea."

In response to specific questions, I offer the following comments:

Question 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?

No. As discussed above, I believe you would be giving people a false sense of security and not properly acknowledging the significant inherent limitations of internal controls.

Question 6: Is the scope of the audit appropriate in that it requires the auditor to both evaluate management's assessment and obtain, directly, evidence about whether internal control over financial reporting is effective?

No. Not as the standard is written. I believe you have set the bar too high and that the demonstrated incremental benefits of the audit do not warrant the incremental costs. The result of the bar being set too high is that the auditor will need to redo significant work already required to be performed by management under Section 404(a) without demonstrating value of the redundancy.

When the concept of redundancies was discussed at the July 29th roundtable, an analogy was drawn between the extra audit work required and the fact that there are two engines on a plane.

To understand the failure of this analogy, one needs to consider the reason why the law was passed so quickly. The specific context included high profile cases like Enron, WorldCom and Tyco. In this context the correct analogy to use would be that four engines are now going to be required on every plane because it was discovered that in recent cases pilots (CEOs) were shutting off the engines (bypassing the internal controls) while they each wore a parachute (lack of personal responsibility). I believe the law passed the House and Senate on a combined vote of 523-3 because the lawmakers saw the need to hold corporate leaders personally responsible for their companies' financial statements and their internal controls, and not to add punitive costs to a process without corresponding benefit. As President Bush mentioned when he signed the Act, the purpose was to "punish wrongdoers". The audit standards should not punish everyone with overarching unjustified requirements.

In retrospect, if the allegations against Mr. Scrushy of HealthSouth are true, would the “internal control audit” as proposed been an effective deterrent to his alleged behavior? Or would a more effective deterrent to him been the fact that he is facing a possible maximum sentence of 650 years in prison and $315 million in forfeitures and fines?

While I am the program manager for a Fortune 500 company’s 404 effort, the views expressed above are my personal opinions.

Respectfully submitted,

Steven A. Forrest

November 20, 2003

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

Re: PCAOB Rulemaking Docket Matter No. 008

Ladies and Gentlemen:

We are pleased to submit this comment letter regarding the above-referenced Board Rulemaking Docket matter. Overall, General Mills supports the intent of the proposed auditing standard. However, we believe the Board should give further consideration to the following areas (1) issue significance and (2) extent of testing and use of the work of others.

Issue Significance:

"More than an inconsequential amount" is not clear:

When determining whether a control deficiency rises to the level of significant deficiency, the draft standard's use of *"more than an inconsequential amount"* introduces new and unclear terminology. We acknowledge that *"significant"* is felt by many to be imprecise, but *"more than inconsequential"* only introduces another imprecise term that in practice is likely to have a different meaning than *"significant"*. We believe that the dollar threshold to be considered *"more than inconsequential"* is much smaller than if *"significant"* were applied.

The examples in appendix D provide support for our belief. While careful consideration is given to whether the quantitative dollar amounts are material, both significant deficiency examples (D-1, scenario A and D-2, scenario A) easily pass the test of being *"more than inconsequential"*. Both examples state that the dollar magnitude cannot be material and that compensating controls to prevent material misstatement are operating effectively. However, both are considered significant deficiencies because there is more than a remote likelihood that a misstatement that is more than inconsequential but less than material could occur. No guidance is given as to what *"more than inconsequential"* means, but the implication is a lower threshold than *"significant"*.

We believe than an excessively low threshold is established by using "*more than inconsequential"*. The implication of a lower threshold is issues that are *"more than inconsequential"* but less than *"significant"* will be labeled significant deficiencies, forcing the attention of the audit committee on issues that may not merit their attention. Additionally, since a combination of significant deficiencies and/or uncorrected significant deficiencies can give rise to a material weakness, inappropriate designation of minor deficiencies as significant deficiencies can have serious consequences.

We propose that the Board remove *"inconsequential"* and simply use *"significant"*. Appendix B uses "*significant*" several times when providing auditors direction on which locations or business units are important to test. This usage is well laid out and should be used as the model for determining what constitutes a significant deficiency, from a magnitude perspective.

<u>Inadequate documentation should not automatically be a significant deficiency:</u>

Inadequate documentation should not automatically rise to the level of significant deficiency. Judgment should not be taken out of the process. It is only after a thorough analysis of all quantitative and qualitative factors that an issue should be labeled a significant deficiency.

Extent of Testing and Use of Work by Others:

<u>Mandatory walkthroughs add unnecessary cost:</u>

A walkthrough is a useful device for training someone on how a business process functions, but assumes a certain level of unfamiliarity with a process. Once an auditor is familiar with a process and has been able to determine that the controls in that process are operating effectively, they do not need to re-perform a walkthrough the next time they are asked to evaluate the same controls.

A walkthrough performed by management should be sufficient, as long as the testing work performed by the auditor does not call management's walkthrough into question. If the walkthrough is suspect, the auditor can use their professional skepticism as to whether re-performance of the walkthrough is necessary.

<u>The extent of auditor test re-performance makes cost of compliance unnecessarily high:</u>

We appreciate the Board's concern regarding the importance of an auditor coming to an independent, fact-based opinion. However, the Board goes too far in requiring the auditor to re-perform significant amounts of tests.

In a well-controlled company, which is fully complying with the letter and spirit of the law, one could reasonably expect to find substantial amounts of management and internal audit testing available for the external auditor to use. Such a testing program is costly. If management is forced to pay the auditor to re-test areas that in the auditor's professional judgment do not warrant re-testing, shareholders are being asked to pay twice while receiving no added benefit from the second review.

As long as the auditor has full and unrestricted access to audit every aspect of the internal control environment and management is able to provide them with credible evidence of effective internal controls wherever they happen to go, the auditor should be able to exercise professional judgment on how much re-performance to do to accomplish a thoroughly supported attestation.

Requirement to obtain principal evidence of effectiveness for all significant accounts and disclosures each year:

Requiring the auditor to obtain evidence for all relevant assertions for all significant accounts and disclosures every year is unnecessarily costly. While a census always provides more certainty than a sample, rarely does it justify the additional cost. In a Fortune 500 company, one could easily expect to find well over 1,000 key internal controls over financial reporting. Many of these controls will remain the same from year-to-year. It is not necessary for the auditor to obtain principal evidence every year to provide reasonable assurance. This is another area where we believe that the auditor should be entrusted to determine which areas are necessary to obtain evidence every year and which only need to be reviewed on a rotational basis (with the rotation to be determined by the auditor).

Direct auditor re-performance of IT controls problematic:

In the walkthrough example B-4, the auditor performs and documents controls through direct interaction with the computer system. The example implies that the auditor is personally entering transactions into the system. While we are entirely supportive of the auditor's testing objectives, we do not support issuing transaction processing authorization to auditors. In fact, giving such authorization to individuals who don't require it would be in direct conflict with the logical access controls of a well-controlled company's general computer controls policy. We recommend that the Board clarify that this type of testing be performed without requiring a company to give the auditors authorization to process transactions directly.

We appreciate your consideration of our comments on the proposed standard and would be happy to follow up with you regarding any questions you may have.

Sincerely,

Kenneth L. Thome
Senior Vice President, Financial Operations
General Mills, Inc.

GLASS LEWIS

December 1, 2003

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

Re: PCAOB Rulemaking Docket Matter No. 008

Dear Sirs:

The Public Company Accounting Oversight Board (PCAOB) is to be commended for its efforts in preparing its Standard for Audits of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements. The new standard provides a more rigorous auditing practice as proscribed by Section 404(b) and Section 103 (a)(2)(A) of the Sarbanes-Oxley Act. These new practices are essential in restoring investor confidence in both the quality of financial information and the trust placed in the auditing profession.

Glass, Lewis & Co., LLC is an independent proxy and financial research firm that provides research to institutional investors. In that regard, we rely on audited financial statements and disclosures that public companies provide to investors and the capital markets. Our staff has many years of experience as financial analysts, auditors and as chief financial and accounting officers and preparers of financial statements. From our perspective it is vitally important to restore the confidence of the investors in the financial statements and disclosures that they receive, and that the numbers therein be accurate.

Given the audit failures at now infamous companies such as Enron, WorldCom, Rite Aid, and Xerox in which investors lost billions of dollars, significant reforms in auditing standards are necessary. The PCAOB must remember these sweeping reforms are essential in preventing future failures and, that "watering down" the proposals resulting in a continuation of audit standards as they are currently practiced will not satisfy investors' needs.

General Comments

Our general comments on the proposed standard are as follows:

1. We believe the standard should set forth the objectives it is trying to achieve at the beginning of the standard. These objectives should assist auditors and companies in implementing the standard. We believe the basic objectives should state that (a) internal controls over financial reporting are necessary to provide investors with confidence the numbers they receive are correct in all material respects, (b) that management's responsibility is to ensure that such controls are properly designed and working effectively to achieve this goal, and that

(c) the auditor's obligation is to perform sufficient testing of the internal controls to provide a basis for expressing an opinion to investors as to whether the internal controls are effective, as reported on by management.

2. We strongly agree with the PCAOB that the auditor must perform sufficient testing of the internal controls to meet the objective set forth in (1) above, and that merely testing the process used by management to asses the internal controls is insufficient to provide an independent auditor a basis for reporting on internal controls to investors.

3. We believe the independent auditor should perform the tests of controls, and not delegate it to another party other than is permitted under existing auditing standards, such as to an internal auditor reporting directly to the audit committee, if the report of the auditor states the auditor, and not the auditor "and others" are rendering the opinion on internal controls to investors. We applaud the provisions in the standard requiring the auditor to perform a walk through (paragraphs 79-83), that describe the nature of tests proposed (paragraphs 88-93) and that the auditor should "design the procedures to provide a high level of assurance that the control being tested is operating effectively." (Paragraph 102)

4. The illustrative report set forth in Example A-1 states it is the independent auditor who has audited management's assessment. Accordingly, we believe it is misleading to investors if the auditor uses the work of management and others without clearly stating that in the report to investors. We believe as the proposed standard notes, that the auditor should directly perform all tests of internal controls designed to prevent fraud. We disagree with the proposed standard that the auditor should be permitted to rely on the work of others in testing controls over subjective and judgment accounts including loss accruals and asset valuation accounts. Studies of restatements have clearly shown this is an area of financial reporting that has resulted in a high number of errors and restatements. Accordingly, we believe it is highly questionable as to why a prudent auditor would rely on the work of the very individuals who have time and time again been involved with and overridden controls on these significant accounts. Furthermore, we believe the standard fails to emphasize sufficiently the need for the work of "others" such as internal auditors, to be independent and report directly to the audit committee. We do believe it would be appropriate for an auditor to rely on the work of an independent auditor who reports directly to the audit committee, provided the auditor complies with existing auditing standards regarding using the work of internal auditors.

5. We believe the audit committee plays a critical role in overseeing management, financial reporting, and the internal controls of a public company. Accordingly, despite the conflicts it might present, we do believe the independent auditor must assess the effectiveness of the audit committee or the auditor will not have performed tests of the entire internal control

environment and structure. It would be wrong and misleading to investors when an auditor has not assessed the effectiveness of oversight by the audit committee, for an auditor to report to investors that all the internal controls have been adequately tested.

6. We wholeheartedly support the proposed requirement that all significant deficiencies and material weaknesses in internal controls be BOTH documented AND reported to the audit committee in a timely fashion. If an auditor identifies such control weaknesses at an interim date, we believe they should be reported to the audit committee at that interim date and not on a delayed basis.

7. The proposed standard fails to provide adequate guidance and emphasis on testing of internal controls over those significant account balances, which have proven to be a source of constant errors in financial statements such as revenue, loss accruals, and asset valuations. Given that this has been a weakness in auditing standards for some time, and has clearly resulted in a risk to both auditors and investors, we urge the PCAOB to provide additional guidance on such high-risk areas. We also believe it is important an auditor not rely on the work of management or others for such high-risk accounts.

8. Management override of internal controls has been a recurring theme for many years. This presents a risk to both investors and auditors alike. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) report on Fraudulent Financial Reporting[1], was undertaken to examine what circumstances surrounded cases of alleged fraudulent financial reporting by registrants of the U.S. Securities and Exchange Commission (SEC). In its findings, 83% of frauds were perpetrated by either the CEO or the CFO of the organization by overriding existing internal controls. ***Most*** of the instances occurred at ***small*** companies in which total assets of the company were below $100 million and whose audit committee met only once per year or was nonexistent. These frauds were not isolated to a single fiscal period and typically involved inflating revenues and assets. These are all areas in which more stringent tests of internal controls could have uncovered or possibly even prevented the fraud before investors lost, in many cases, their lifetime savings. Accordingly, we believe the final standard should provide greater emphasis and guidance to auditors in how they might detect weaknesses in internal controls, which would allow such an override to occur. Since the audit committee plays an integral part in preventing such overrides, we once again believe the proposed standard is absolutely correct to require the independent auditor to assess the oversight of the audit committee.

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[1] *Fraudulent Financial Reporting: 1987-97 An Analysis of U.S. Public Companies.* Page 3. Committee of Sponsoring Organizations of the Treadway Commission, 1999.

9. We do not believe exceptions should be granted from the standard, or any provisions thereof, for small businesses. When companies chose to access the capital markets and take money from investors, they also take on an obligation, regardless of size, to ensure their financial disclosures are transparent, accurate and complete on a timely basis. Unfortunately, as mentioned above, many smaller companies have failed in their obligation to investors in this respect. Previous studies of restatements have identified the significant number of restatements by smaller companies. For example, companies with under $100 million in revenues did 48% of all restatements for the five-year period ending December 2002.[2] Accordingly, it would be improper to make any exemption for small businesses. However, we do believe the proposed standard should be more articulate in noting that the internal control structure for a small business may be significantly different than for a large international conglomerate. It would be useful for auditors, we believe, if this is more fully discussed in the standard, as well as how those differences translate into the differences in testing of internal controls in different environments.

10. We do not believe it is appropriate for an independent auditor to report on internal controls to investors, if that auditor has not adequately tested internal controls over each significant account and type of transactions each year. In recent years auditors have "rotated" tests of controls, testing some controls such as over the revenue cycle, while testing other controls such as those over the production cycle in other years. We believe it would be misleading to investors for an auditor to perform tests on a rotating basis while at the same time issuing a report that leads investors to believe all significant internal controls have been tested. Accordingly, we believe the standard should be explicit in prohibiting testing of controls on a rotating basis, or revise the standard report to clarify for investors in a transparent basis, that rotating testing was performed.

11. Our experience also tells us that an auditor will likely fail to recognize significant internal controls and control weaknesses unless they have a good fundamental understanding of the business. We are concerned that in many situations, we have seen junior auditors performing control testing without adequate supervision. Accordingly, we believe the PCAOB should strengthen the guidance in the standard and more fully discuss the need for the auditor to gain a complete understanding of the business, what are the critical factors that influence the success of the business, and how they influence, including from a risk management perspective, the internal controls over financial reporting. We also believe the PCAOB should include inspection of the required business and technical accounting and auditing training as part of its ongoing inspection efforts.

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[2] An Analysis of Restatement Matters: Rules, Errors, Ethics, For the Five Years Ended December 31, 2002. Huron Consulting Group, January, 2003.

12. The proposed standard provides little guidance on how controls over compliance with laws and regulations interface with internal controls over financial reporting. As we have seen in some of the frauds committed in recent years, there were violations of laws and/or regulations that did ultimately have a significant effect on the financial statements. Accordingly, we believe the proposed standard could be significantly improved from an investor's perspective if the standard discusses and mandates testing of controls over compliance with laws and regulations that could have a material affect on a business and its financial statements, including disclosures.

13. We are concerned that in some instances, the "tone" of the document reads more like the auditors should be concerned about over testing rather than under testing of controls. We also have watched as auditors have had undue pressure placed on them to reduce fees, and with that, they have reduced audit testing by undertaking such actions as rotating of testing of internal controls. Some have argued that the cost of internal control testing greatly exceeds the benefits to be derived there from. Some have argued that this exercise is nothing more than auditors trying to "gouge" companies for excessive fees. We could not disagree more with those arguments. Audit fees for the S&P 500 were approximately $1.2 billion in 2001. Investors on Enron alone watched as the value of their stock investments plummeted by over $60 billion. We believe that the costs incurred to comply with the proposed standard would be but a "drop in the bucket" when compared to the benefit investors would gain from increased accuracy in the financial statements they receive.

    We believe the confidence investors will ultimately place, or not place, in the PCAOB will be determined by whether in the future there are significantly fewer financial statements investors receive with errors in them. A good start to gaining that confidence will be for the PCAOB to adopt a standard that ensures an independent set of eyes has thoroughly tested the internal controls that provide reasonable assurance the financial statements are correct in all material respects, including the appropriate disclosures.

14. Some have also argued that the "intent" of Sarbanes-Oxley was that Section 404 would not have any impact on audit fees, given the language that refers to the audit of the financial statements and internal controls being one engagement. Earlier drafts of the legislation did not discuss the one engagement notion. However, in discussions I had with the Staff of the Senate Banking Committee during the drafting of the legislation, they stated a desire to replicate what had been done in the early 1990's in the legislation requiring audits of internal controls of financial institutions. That provided the foundation for the drafting of Section 404. However, the Financial Executives International pushed for language that would result in the audit of the financial statements and the audit of internal controls being performed as one engagement. I also recall discussing this with the Senate Banking Staff and recall that so long as an appropriate audit of BOTH the financial statements

and internal controls was done, whether it is one or two engagements was not significant. However, it was very clear to me at the time that the intent of the legislation was to result in a mandate similar to that in the legislation for financial institutions. As a result, I believe the intent of the legislation was to ensure that an audit was performed of internal controls of sufficient scope to ensure the internal controls were in fact operating effectively, not just an audit of the process management used in making their assessment.

We appreciate this opportunity to comment on the PCAOB's proposed auditing standard and its efforts to improve the quality of audits and financial statements. Our comments regarding the proposed standard as a whole follow below.

Specific Comments

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?

Yes – *For an auditor to be able to attest to any assertion, an audit of management's assertion has to be made; therefore, the terms "audit" and "attestation" essentially become interchangeable. However, it is imperative the auditor tests the internal controls and not just the process management uses in assessing the design and effectiveness of the controls.*

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?

Yes – *Given the enormous financial losses of past audit failures, continuing to allow piece-meal audits does not give a complete view into the entire happenings at a company. Instances where we now know that there were material weaknesses in internal controls, including Rite Aid, Xerox, and WorldCom, to name a few, cost investors billions when a lack of effective internal controls contributed to false and misleading financial statements being provided to investors and regulators. Neither the audit of internal controls nor the audit of the financial statements should be performed in isolation. Without the additional financial statement audit, the true effectiveness of the internal controls (e.g., the accuracy of reported amounts) is not known. Discrepancies identified during the financial statement audit are an indication of the quality and efficiency of the internal controls.*

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?

See answer to question 2 above. If an auditor would be required to perform essentially the same procedures on the financial statements for an audit of internal controls as for *an audit of the financial statements, the company would be duplicating efforts-- an impracticable and costly alternative no company would likely choose.*

Question regarding the costs and benefits of internal control:

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?

We believe "beefing up" the discussion of how differences in business enterprises, including differences in size, affect the internal controls, internal control environment, the assessment process used by management, etc could enhance the standard. Since the proposed standard allows a large degree of auditor judgment in determining what evidence is sufficient, significant variations are still possible and can be subject to interpretation for individual companies. As previously mentioned, a significant number of frauds involving financial reporting occur at small and medium-sized companies. COSO's study of Fraudulent Financial Reporting concluded, "The relatively small size of fraud companies suggests that the inability or even unwillingness to implement cost-effective internal controls may be a factor affecting the likelihood of financial statement fraud (e.g., override of controls is easier)." In other words, since fraud often happens at small and medium-sized companies, controls at small and medium-sized companies are just as (if not more) important and should be given the same scrutiny as larger companies although different methods may be needed to do so.

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.

Yes – Each audit firm should individually determine the competence, training, and supervision of its own audit personnel in accordance with its risk assessment of the engagement and standard practices according to AU 150. However, the standard on auditing internal controls should be expanded to ensure that the auditors at all levels (and especially the ones actually performing the work) understand the industry, business transactions of the company under audit, its business risks, and how internal controls should work in that business. This should include training, work review, and supervision of audit procedures. An example of how imperative adequate business risk training can be found in the SEC's Litigation Release 48372 in which the lead audit partner was implicated in an audit failure for "recklessly failing to plan and supervise…audits".[3] In that case, the entire audit team was new to the engagement except for the partner. Due to their inexperience and lack of supervision, certain necessary audit procedures were

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[3] http://www.sec.gov/litigation/opinions/34-48372.htm

misapplied and the staff did not have the knowledge to exercise professional skepticism. The result: a material misclassification and material misstatement in the financial statements that was undetected.

Questions regarding evaluation of management's assessment:

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 – Evaluating management's assessment alone is not sufficient. By requiring both evaluations, the auditor obtains evidence about whether management is competent, has integrity and that internal controls over financial reporting are effective.

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

Yes – The requirements reinforce for auditors and management how critical well-designed internal controls are to quality financial reporting.

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?

Yes – Inadequate documentation is consistent with the definition of an internal control deficiency. Our experience has shown, especially in businesses with international operations, that a lack of consistent documentation for employees, and/or a lack of training, results in deficiencies in the effectiveness of internal controls. If there is a lack of documentation of internal controls, we believe it is likely that at least some employees will not fully understand and perform the functions necessary for controls to work properly. In those instances, a lack of documentation of controls also results in a lack of accountability within the organization. In fact, we believe much of the uproar among companies having to undergo testing of internal controls, is caused by a failure of companies to adequately document and/or update their documentation of internal controls, thereby resulting in a lack of reasonable controls in some instances, and the need to incur costs that should have been incurred all along to provide for reasonable controls over financial reporting.

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 – Independently performing walkthroughs of control activities is one of the strongest forms of audit evidence that cannot be obtained through documentation or reliance on the work of others. We strongly applaud the PCAOB for adopting this requirement.

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?

Unequivocally yes – see above.

Question regarding testing operation 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?

The auditor will be required to report on the effectiveness of internal controls as of a date in a year. Accordingly, the auditor should perform sufficient testing during the relevant period to ensure the controls are effective at the specified point in time. It would be extremely misleading to investors to report on the effectiveness of controls as of a date, if in fact those controls had not been tested during the year. As a result, "rotating testing" of controls, whereby only a portion of the internal controls are tested each year should be explicitly prohibited in the final standard. If testing of internal controls is permitted and performed on a rotating basis in the final standard, that should also be required to be communicated in the auditor's report.

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?

Using the work of others should only be permitted to the extent these procedures would be permitted in a financial statement audit. The crux of the audit is to have an independent external opinion formed by examining the controls themselves. When reliance on management's work is allowed, management is effectively providing the opinion on that portion of the audit. Investors would hardly consider this to be an independent audit or report.

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

The categories are appropriately defined. However, as previously noted, we believe the proposed standard provides for too much reliance on the use of management or others, except with respect to an internal audit function that is technically competent and that reports directly to the audit committee.

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?

See below #15.

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)?

If an auditor plans to rely completely on a test for the opinion, the auditor should be required to have performed or at least adequately re-performed the test to an appropriate extent. Existing audit standards provide appropriate guidance with respect to the reliance on the work of internal auditors. We do not believe any reliance should be placed on the testing performed by individuals who are not independent within existing auditing literature if the report states it is the report of an independent 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?

Yes – see above #15.

Questions regarding evaluating results:

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?

Yes – *Providing three levels of deficiency definition is an improvement on reportable condition and material weakness as used in the existing Auditing Standards Board guidance. However, one of the problems in the past has been that auditors have failed to report even material weaknesses until shortly before or after they were terminated. As a result, the PCOAB should consider and assess whether the new standard will, in fact, improve the likelihood that once deficiencies are identified, they will actually be reported to the audit committee on a timely basis.*

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?

Yes – *For example, in the WorldCom case, a lack of timely and periodic reconciliation of intercompany accounts did contribute to errors in the financial statements.*

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

Yes – In order to determine that an identified internal control deficiency is neither a significant deficiency nor a material weakness, its severity must be determined. Appropriate classification would not otherwise be possible.

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 – Both from an auditor's liability standpoint and for management's own continuous improvement, all deficiencies should be communicated to management in writing. The deficiencies should also be required to be communicated to the audit committee members as representatives of investors. All deficiencies need not be listed in the opinion, but those findings could be helpful to management and the audit committee in determining areas that need strengthening or may become a significant deficiency in subsequent periods.

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

Yes

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 – As mentioned in the opening remarks, the ineffectiveness of audit committees appeared to weigh heavily on the ability of fraud perpetrations and the reliability of the financial statements as a whole. The audit committee plays a large role in establishing the "Tone at the Top" in an organization. This tone is imperative for a reliable control environment to be established and should be communicated to interested parties by auditors. Auditors should already be considering this as part of overall engagement risk and client acceptance policies.

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

Yes – Although some have raised the potential for conflict as the audit committee hires the auditor, that conflict is less significant in our opinion than an auditor not testing a very material and significant part of the control environment – the oversight function. It is inconceivable that one could report on internal controls effectiveness knowing that in 83% of financial frauds management has overridden the controls and, perhaps the most significant control addressing such overrides, is the oversight by the audit committee. An audit committee, including its financial expert plays an important role in selecting and overseeing the Chief Financial Officer. As a result, the auditors should test the effectiveness of the audit committee. This testing should include the audit committee's process and involvement in handling reports of fraud, the review of the scope of the audit, the responsiveness to issues raised by auditors, and the level of review of related *party and complex transactions. The review should also consider the role and involvement of the financial expert. Congress and the SEC would not have mandated the need for and disclosure of a financial expert on the audit committee if that were not a critical role.*

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 – Either option may be appropriate; however, other extenuating circumstances could make one more preferable than the other on a case-by-case situation.

Questions regarding forming an opinion and reporting:

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?

Yes – By its very definition, a material weakness implies that a significant control is not operating effectively and should result in an adverse opinion on the company's internal control. Material weaknesses should be disclosed in order to provide more transparency in financial information. Subsequent to changing auditors, Rite Aid and Xerox disclosed in 8K's filed with the SEC[4] that material weaknesses had been noted in their internal control. Had investors known of the weaknesses on a timely basis, their decisions may have been different and they may not have lost over $3 billion as a result of subsequent restatements and decreased stock valuations.

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

No – A material weakness is indicative that a pervasive risk is present that due to its very nature would be difficult, if not impossible, to mitigate with other controls or additional procedures

27. Do you agree with the position that when the auditor issues a nonstandard 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?

Yes – Existing confusion would be greatly reduced by this change in language.

Questions regarding auditor independence:

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[4] Rite Aid Corp Form 8-K, November 19, 1999 and Xerox Corp Form 8-k, October 5, 2001.

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

Yes – Guidelines need to be established that define how much assistance auditors can provide in management's documentation of internal controls without having to opine on their own work. We do not believe an auditor should perform the documentation of internal controls, even if management takes responsibility for that documentation. We commend those accounting firms, such as Grant Thornton, that have publicly expressed a similar view.

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

Yes – An auditor should be prohibited from acting in a consultant role in designing and implementing internal controls over financial reporting and documenting existing procedures for management. These are services that would impair independence with respect to the audit of internal controls over financial reporting.

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 – Just as the requirements differ at quarterly periods versus annual ones for audits of the financial statements, a differing responsibility would be expected at quarterly periods for audits of internal controls. The required responsibility should be lessened since no audit is being performed as of these interim periods. Requiring the auditor to issue a quarterly audit opinion on internal controls would also require a quarterly audit of the financial statements. The proposed standard's requirements as they relate to management's quarterly certification are consistent with the requirements for reviewing quarterly financial information.

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

Yes – The scope proscribed is essentially the same level of review that is performed on the financial statements for the corresponding periods.

Summary

The proposed standard makes great strides in improving the reliability of financial information and making management more accountable for its processes and procedures. As an advocate of investors, we hope the final rules will not be swayed by the outcry of affected parties that the proposal will be too costly and time intensive to implement.

The PCAOB's consideration of these comments is greatly appreciated. If further clarification of these points is desired, please contact us.

Regards,

Lynn E. Turner

Lynn E. Turner
Managing Director of Research
Glass, Lewis & Co., LLC

cc: Mr. Donald Nicholiasen, Chief Accountant, Securities and Exchange Commission

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[hard copy to follow by mail]

21st November 2003

Dear Sir,

PCAOB Rulemaking Docket Matter No. 008

We are writing in response to your invitation for comment on the Proposed Auditing Standard: *An Audit of Internal Control over Financial Reporting performed in conjunction with an audit of Financial Statements* ('the Proposed Standard'). As our shares are listed on the New York Stock Exchange we are required to comply with the Sarbanes-Oxley Act of 2002 ('the Act') and, accordingly, have a vested interest in the Proposed Standard. We would like to make the following observations:

(1) Direct evaluation by an auditor of a company's internal control over financial reporting

Section 404 (a) of the Act and the SEC's related implementing rules require the management of a public company to assess the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year and to record its conclusions in the Annual Report. Section 404 (b) requires the company's auditor to attest to, and report on, management's assessment. Paragraph 4 of the Proposed Standard states that the auditor's objective is to 'express an opinion on management's assessment of the effectiveness of the company's internal control over financial reporting.'

The Proposed Standard goes beyond this requirement though and requires the auditor to both evaluate management's assessment and obtain, directly, evidence about whether internal control over financial reporting is effective. We question whether the direct audit of internal control over financial reporting on top of the required evaluation of management's assessment is necessary or appropriate for the following reasons:

(i) If it had been Congress's intention that internal control over financial reporting be audited directly why does Section 404 not explicitly require this?

(ii) The Act / Proposed Standard require a company's management to perform a thorough evaluation of its internal control over financial reporting, as set out in paragraphs 41 to 44. We believe the desire to obtain a clean audit report will provide the necessary pressure for most companies to ensure thorough evaluations are performed in line with the requirements. In some instances management's assessment of its internal controls will utilise more specialised / experienced staff which will result in better comfort / information compared to the direct testing of controls by the auditor. Management's assessment has much value but since paragraph 104 restricts the use by the auditor of management's work in a number of areas and paragraph 109 requires the auditor to 'perform enough of the testing himself or herself so that the auditor's own work provides the principal evidence for the auditor's opinion' much of management's work will need to be reperformed. This is clearly duplicative. We believe that auditors should be able to rely on controls testing performed by internal staff where they have satisfied themselves, using their professional judgement, of the competence and objectivity of the staff performing the work.

We recognise that Section 103 of the Act requires certain specific evaluations to be reported by the auditors, including whether internal controls facilitate the maintenance of accurate records, provide reasonable assurance that transactions are recorded and reported in accordance with GAAP and whether transactions have been appropriately authorised. These areas should be required to be included within the scope of the work performed by management and we believe that auditors should be able to rely on the work of management where, in their professional judgement, it is reasonable to do so.

The additional work required by the auditor to directly evaluate internal control over financial reporting, rather than focusing on the sufficiency of work performed by management and assessing whether this provides a reasonable basis on which to form a conclusion, will result in significant additional costs and we are not convinced this will yield a proportionate level of shareholder benefit.

(2) Assessment of the effectiveness of Audit Committee by the auditor

The Act makes the audit committee directly responsible for the appointment, compensation and oversight of the work of the auditor. Paragraph 57 of the Proposed Standard requires the auditor to specifically evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting. We believe that it is not appropriate for the auditor to have a specific responsibility for evaluating the body that supervises its work. In our opinion the effectiveness of the audit committee should be assessed by the Board of Directors as a whole.

We agree that it is important for the effectiveness of the audit committee to be assessed but feel that some of the factors listed in paragraph 57 are too subjective. In addition, paragraph 57 lists the 'amount of time that the audit committee devotes to control issues' as a consideration in evaluating its effectiveness. We believe that it is the quality of time devoted to control issues rather than the amount of time that is relevant.

(3) Compensating controls

The Proposed Standard does not appear to take account of the complex interaction of controls that exists in practice. A low level control may fail but material differences may still be picked up by higher level controls performed later in a process. We believe that the initial failure of one control coupled with the successful operation of a compensating control should not lead to an adverse opinion.

(4) Acquisitions

The issue of material acquisitions not previously subject to regulation by the Act, which are completed towards the end of a company's financial year, needs some consideration by the Board. Such transactions may not allow sufficient time for management to properly evaluate the internal controls over financial reporting within the acquired entity and some guidance as to how this should be treated / disclosed is requested.

(5) Definitions / examples

It would be helpful to provide greater clarity around the definitions of a ‘significant deficiency’ and ‘material weakness’, as these terms are still hard to interpret.

We appreciate your consideration of our comments on the Proposed Standard.

Yours faithfully,

Paul F Blackburn
SVP, Corporate Accounting

Goldman Sachs

November 21, 2003

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

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

Goldman, Sachs & Co. strongly supports the Public Company Accounting Oversight Board ("the Board") in its mission to oversee the auditing of public companies and to protect the interests of investors, specifically in the preparation of informative, accurate, and independent audit reports. Therefore, we appreciate the opportunity to comment on the above-referenced standard.

In general, we support the Board's proposal and believe that it will significantly enhance the value of an auditor's opinion on financial statements. And, while we are concerned about the additional costs and burden of work that will be placed on issuers, we acknowledge the need for a more meaningful and effective process for overseeing internal controls and we recognize that this cannot be achieved without additional expense. We do, however, have some comments and concerns that we hope will be helpful to the Board; they are noted in the attachment to this letter.

Once again, we appreciate the opportunity to offer our views and we would be happy to meet with you to discuss them.

Sincerely,

/s/ Sarah E. Smith

Sarah E. Smith
Chief Accounting Officer
(212) 902-5675

ATTACHMENT: Comments and Concerns

Creation of an Appropriate Environment

Paragraph 150 precludes management from concluding that a company's internal controls over financial reporting are effective if a single instance of a material weakness is identified, material weakness defined as *more than remote likelihood* that a *material misstatement* will not be prevented. Our concern is that the proposal sets too low a trigger event for an outcome that could have very serious financial and reputational consequences for an issuer. And, when the "sufficiently in advance of the as of date" remediation requirement is considered, we believe there is substantial risk that an open and communicative environment for the purposes of identifying and deliberating internal control issues may not be fully realized.

Further, the auditor is required to report in writing all "significant deficiencies" to the audit committee. A "significant deficiency" is defined as a single deficiency or a combination of deficiencies, that results in a *more than remote likelihood* that a misstatement of the annual or interim financial statements *that is more than inconsequential* in amount would not be prevented or detected. We believe that for a large, complex, global organization, to set the levels at "more than remote" and "more than inconsequential" is likely to generate a multitude of marginal items, diluting the audit committee's ability to focus on issues material to the financial statements.

Accordingly, we would offer the following comments and suggestions:

Definition of "Significant Deficiency" and "Material Weakness"

A significant deficiency should be defined as a deficiency that results in a *reasonable possibility* that a *material* misstatement in the financial statements would not be prevented. Under this definition, the audit committee would be alerted to critical control issues requiring their immediate focus and attention. Material weakness should be re-defined as a deficiency that results in a *probable* likelihood that a *material* misstatement in the financial statements would not be prevented. We believe this would ensure that both management and the auditor would properly and quickly focus on those issues that could lead to a material misstatement of the financial statements.

Remediation Period

Paragraph 151 would prohibit management from concluding that controls were free of material weakness if a material weakness was identified in the fourth quarter and yet was not remediated "sufficiently in advance of the as of date." Further, this situation would trigger an adverse (or scope limitation) opinion by the auditor. We believe this requirement does not credit management with best efforts where a material weakness is discovered and acted upon immediately, including execution of an appropriate remediation plan. Under the proposal, in that situation the opinion would still be adverse, simply because remediation wasn't completed "sufficiently in advance of the as of date." We have similar concerns over the subsequent event period. Management during the period-end close may detect an issue, adjust the financial statements accordingly, implement and complete a remediation plan, all prior to the release of the year-end financial statements, yet still receive an adverse opinion because of the "sufficiently in advance of the as of date" requirement.

At the same time, the Board refers to the audit of internal controls and the audit of the financial statements as an integrated audit resulting in two opinions. During a financial statement audit, the auditor may propose adjustments to the financial statements, and management is accorded the opportunity to adjust the financial statements, and receive an unqualified opinion. If the audit of internal controls over financial reporting performed in conjunction with an audit of financial statements is structured as a single engagement, and we agree with the Board that it should be, we would propose that management have the same opportunity to correct any internal control weaknesses, and still receive an unqualified opinion. In paragraph 95, the Board acknowledges that certain controls are performed after the "as of date," and it requires the auditor to test those controls and include them in the "as of date" opinion. We propose that actions taken by management during this period should be treated identically, with the ability to remediate any weaknesses discovered during the period-end close, up to and including the date on which the audit opinion is rendered. We believe this will foster an open and communicative environment in which management and the auditor are eager to both identify problems and remediate them whenever they are identified.

Material Misstatements Identified by Auditors

Paragraph 126 lists examples that would be regarded as significant deficiencies and strong indicators of material weaknesses. One such example is a material misstatement in the financial statements in the current period identified *by the auditor* prior to the company's internal control structure identifying the issue. We believe there are situations where a breakdown in an internal control that could lead to a potential misstatement in the financial statements would be effectively detected and resolved by management's period-end control procedures. Yet, under the proposal, if the auditor were to identify the issue first[1], it would trigger a strong indicator that a material weakness exists. In this situation, it seems to us unduly harsh that management not receive credit for the full range of controls in place that would have identified the error, simply because the auditor identified the issue prior to management. Accordingly, we would suggest that when a material misstatement is found by the auditor, the auditor should conduct an immediate assessment of the downstream controls, and only in the event that the auditor were to determine these to be ineffective would a material weakness be deemed to exist.

In summary, we believe the suggestions outlined above would significantly improve the likelihood that an appropriate environment would be created by which the Board would achieve

[1] Typically the auditor would begin their fieldwork simultaneously with the period-end close.

its objective of enhancing the quality of audits and of ensuring the swift identification and remediation of control issues.

Reliance on the Work of Others
Paragraphs 103 through 110 limit the extent to which the auditor can rely on work performed by others. The proposal states that (i) an auditor cannot place any reliance on work performed by others in the areas of fraud controls, period-end financial reporting controls, certain general information technology controls, or walkthroughs; (ii) limited reliance can be placed in the area of non-routine, judgmental transactions or areas where the risk of failure of the control to operate effectively is deemed to be high; and (iii) wider reliance may be placed by the auditor on work performed by others involving routine transactions.

While we fully agree that the auditor must gather the "principal evidence" to support the audit opinion, and that reliance by the auditor on the company for the review of required period-end financial reporting controls or for performing walkthroughs should be prohibited, we think that giving prescriptive rules to the auditor in the other areas referenced would not be optimal. In these other areas, an auditor should be allowed to exercise judgment as to the level of reliance that can be placed on management and its control structure for the purposes of testing operational effectiveness of internal controls, as we believe this will provide incentive to companies to establish and maintain a robust system of internal controls.

Accordingly, we would propose that the auditor perform a full assessment of the control environment and "tone at the top" before determining the scope of the audit work. This assessment would include the audit committee, internal audit and other control areas such as controllers, which compose the organization's financial reporting oversight. If such an assessment revealed a relatively weak control environment, we would expect auditors to question even the extent to which they could rely on the company's work involving routine transactions. Conversely, a strong control environment would indicate that more reliance could be placed on work performed by others.

Assessment of the Audit Committee
Paragraphs 56 through 59 and Paragraph 126 discuss the inclusion of the audit committee in the scope of the audit opinion. While we agree that an ineffective audit committee represents a deficiency in the control environment, we are troubled by the inherent conflict of interest present in requiring the auditor to give an opinion on the committee that is directly responsible for his or her appointment, retention and compensation. Further, if such a review is included in the audit opinion, management would be required formally to evaluate the audit committee, notwithstanding its own reporting relationship to the committee. Alternatively, we would propose that the auditor perform a review of the effectiveness of the audit committee, not as part of the audit opinion, but rather as an integral part of the overall assessment of the company's financial reporting oversight when determining the scope of the audit work to be performed and the extent to which the auditor may rely on the work of others. Accordingly, we believe that this assessment should replace the specific inclusion of the audit committee in the scope of the audit opinion.

Assessment of the Compliance Department

Paragraph 126 of the proposal states an ineffective compliance department in a highly regulated industry would be considered a significant deficiency, which implies that the compliance department would be included within the scope of the audit opinion. While we agree that such ineffectiveness would be at least a significant deficiency, the specific inclusion of compliance seems to us inconsistent with the direction provided by Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, which specifically limited scope to internal controls over financial reporting (and not to regulatory or compliance issues)[2]. Furthermore, the expanded scope appears to establish a higher standard for particular industries, and we do not believe industry specific requirements were intended by the proposal.

In contrast, we would again propose that the compliance department, and other areas within a company that are an integral part of the control infrastructure, should be considered in a broad assessment of the control environment. Ineffectiveness of such areas should be considered by the auditor in determining the scope of work and the extent to which reliance can be placed on the work of others. Accordingly, we believe that this assessment should replace the specific inclusion of the compliance department in the scope of the audit opinion.

Walkthroughs

Paragraphs 79 through 83 require the auditor to perform "walkthroughs." In a walkthrough of significant business processes, the auditor traces all types of transactions and events, both recurring and unusual, from origination through the company's information systems until they are reflected in the company's financial reports. We believe this is an excellent proposal, and that walkthroughs confirm an auditor's understanding of the flow of transactions, the nature of the business, the design of internal controls, and the interrelationship of controls to processes. We believe this is a welcome return to basic audit techniques and that the auditor should be required to perform the walkthrough directly rather than rely on the work of others.

* * * *

[2] Section 404 scope has been consistently bounded with a focus on financial reporting; e.g., the proposal defines safeguarding of assets in Appendix C within the context of financial reporting.

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November 21, 2003

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

Via e-mail: 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*

Dear Board Members and Staff,

We appreciate the opportunity to comment and commend the Public Company Accounting Oversight Board's ("Board" or "PCAOB") efforts on the proposed auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*. Our concerns with respect to the proposal are expressed below and in Appendix A, which contains our responses to the questions put forward by the Board. Additional paragraph-level comments are presented in Appendix B. Other recommendations are included in Appendix C.

Management's Assessment of Effectiveness

Management is required to present a written assessment of the effectiveness of internal control over financial reporting. The auditor's attestation of management's assessment is referred to as the audit of internal control over financial reporting ("audit of internal control"). There is a clear distinction, however, between management's **assessment** and their **assertion** and the auditor's responsibilities with respect to such. We believe that an audit of internal control is an attestation of management's **assertion**, rather than their **assessment**, of internal control effectiveness.

Management makes an assertion as to whether internal control is effective, just as management makes assertions that are embodied in the financial statements. Management's assessment is their process of determining whether internal control over financial reporting is effective. Accordingly, management's assessment process supports their assertion. When performing an audit of internal control over financial reporting, the auditor evaluates management's assessment process and management's assertion of effectiveness. Further, the auditor is not prohibited from opining directly on internal control over financial reporting. It is more evident that when opining directly, the auditor is opining on management's assertions regarding internal control effectiveness and not management's assessment. Accordingly, we object to the use of the term assessment to describe the auditor's attestation. Management's report should also contain their assertion regarding the effectiveness of internal control over financial reporting and not their assessment or evaluation of such effectiveness.

Safeguarding of Assets

We suggest that the Board enhance Appendix C to provide additional guidance on safeguarding controls that fall within the scope of internal control over financial reporting. In addition, as indicated in our response to question number 18, it would be very useful to provide examples that illustrate internal control deficiencies relating to safeguarding of assets that are financial reporting in nature, deficiencies that relate to the assertions about safeguarding that management is required to make under Section 404 of the Sarbanes-Oxley Act of 2002, and deficiencies in safeguarding that are not within the scope of financial reporting and Section 404 assertions.

Revisions to Existing Interim Standards

The Board appears to be using this proposed standard to revise, summarize, and/or supplement existing interim standards, including independence, fraud, the work of internal audit, the work of other auditors, analytical procedures, interim reviews, and filings under federal securities statutes. The Board has also revised the requirement related to the performance of substantive procedures on material account balances and has provided significant guidance with respect to the company's use of a service organization.

With respect to service organizations, we do not clearly understand how this relates or may even supersede existing interim standards (AU Section 324, *Service Organizations*). While summarizing some of the content in the existing standards, the proposed standard changes the content of the interim standards. For example, the proposed standard, among other things, appears to change the requirements for when a service organization is part of the company's information system (paragraph B26) and omits the fact that an auditor's report on controls placed in operation also provides evidence as to whether the controls have been placed in operation (paragraph B30).

We urge the Board not to use this proposed standard as a vehicle for revising, summarizing, and/or supplementing the interim standards. When summarizing existing literature or restating it using different words, the intent, meaning, and requirements may be inadvertently altered. Further, when revising, summarizing, and/or supplementing the interim standards, the requirements for an audit of internal control versus an audit of the financial statements may be undistinguishable. Accordingly, we suggest that the Board amend existing interim standards to reflect newly adopted requirements. We prefer that requirements and guidance relating to the same subject matter be kept intact to promote compliance with the standards, rules and regulations. The Board may choose to only include additional considerations or requirements necessary for the opinion on internal control over financial reporting in the proposed standard, while referencing the existing interim standard for the fundamental definitions, requirements, and guidance. The Board should, at a minimum, delete the requirements and guidance from the interim standards that are no longer applicable.

Authoritative Status of Appendices

The Board has indicated that the appendices carry the "same authoritative weight" as the standards. We recommend that the Board clarify whether the examples are being used to establish requirements, including whether they are setting a standard for documentation. In addition, we suggest clarifying whether the Board's statement also applies to the interim standards. The Board should perform a standard-by-standard review of the interim standards prior to adopting the "same authoritative weight" requirement for such standards.

We would be pleased to discuss any of our comments with you. If you have any questions, please contact Mr.. John L. Archambault, Managing Partner of Professional Standards, at (312) 602-8701.

Very truly yours,

John L. Archambault

Grant Thornton LLP

Appendix A – Responses to Questions

Questions Regarding an Integrated Audit of the Financial Statements and Internal Control Over Financial Reporting

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?

As discussed in our cover letter, we object to the use of the term "assessment" to describe the auditor's attestation. Accordingly, it is not appropriate to refer to the auditor's attestation of management's "assessment" of the effectiveness of internal control over financial reporting as an audit of internal control over financial reporting ("an audit of internal control"), but it is appropriate to refer to the auditor's attestation of management's "assertion" as to effectiveness as an audit of internal control. An "audit" is an attest engagement that is designed to provide a high level of assurance. In an audit of internal control, a high level of assurance is obtained to provide a basis for expressing an opinion on management's assertion.

In the past, the American Institute of Certified Public Accountants used the terms "audit" and "examination" synonymously. The term audit was restricted to the audit of the financial statements, while the term examination referred to the same level of assurance given on other management assertions. Whether the auditor's attestation of management's assertion is referred to as an audit or an examination is not very important, as very few people ever grasped the distinction.

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?

An audit of internal control over financial reporting and an audit of the financial statements are two types of attest engagements that provide a high level of assurance on different subject matter. Although the auditor may gain efficiencies by performing both the audit of internal control and the audit of the financial statements, the auditor's procedures for each engagement should be sufficient to reduce attestation risk to an appropriately low level. We believe that each engagement can be performed without the performance of the other, and that it is important to preserve attestation standards that support audits of internal control as a separate service.

An audit of internal control provides reasonable assurance about whether the company maintained, in all material respects, effective internal control over financial reporting. The identification of a material weakness or a significant deficiency, however, does not necessarily imply that a material misstatement in the financial statements exists. Nor does the lack of the identification of a material misstatement in a financial statement audit imply that internal control is effective. Accordingly, an audit of the financial statements is not necessary to opine on the effectiveness of internal control over financial reporting. Further, due to the performance of substantive procedures, an audit of internal control is not necessary to perform a financial statement audit.

In addition, there may be situations where a separate attestation standard that supports audits of internal control, without the performance of a financial statement audit, may be necessary. For example, an auditor may be asked to opine on the effectiveness of an entity's internal control as of an interim date where an audit of the financial statements has not been performed. The auditor may also be involved in a re-audit situation, where the auditor that performed the audit of internal control is not the auditor that re-audited the financial statements. An auditor may also be asked to perform an audit of internal control for registered investment companies or issuers of asset-back securities that are not subject to the Section 404 requirements but may be subject to the PCAOB's Auditing and Related Professional Practice Standards.

Therefore, while we believe the auditor can perform an audit of internal control over financial reporting without also performing an audit of the financial statements (and vice versa), we cannot offer a specific situation where such a request would arise for companies required to include in their annual report a management report on internal control over financial reporting. For such companies, it is appropriate to require that the same auditor perform both the financial statement audit and the audit of internal control over financial reporting, as we believe this is the intent of the Act and in the public interest.

Our response to question three discusses the auditor's procedures in an audit of internal control over financial reporting when an audit of the financial statements has not been performed.

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 is not an appropriate alternative to require the auditor to perform work with regard to the financial statements comparable to that required to complete the financial statement audit. As described in our response to question number two, an audit of the financial statements need not be performed in order to execute an audit of internal control. However, it is appropriate to consider the evidence obtained in a financial statement audit in light of the auditor's conclusions regarding the effectiveness of an entity's internal control over financial reporting.

Where a financial statement audit is not performed, however, certain procedures with respect to obtaining an understanding of the entity and its environment and communicating with the auditor of the financial statements may need to be more extensive. For instance, the auditor should perform sufficient procedures to ensure that they appropriately identify controls related to relevant financial statement assertions for significant accounts and disclosures in the financial statements. Where the auditor has not performed the financial statement audit, the auditor may need to perform additional inquiries and/or other procedures to enhance their understanding of such processes and controls. The auditor may also need to communicate with the current auditor as to their internal control findings, any material misstatements noted, and any disagreements with respect to such matters. Such information, however, may be obtained through discussions with management and/or those charged with governance.

Conversely, the performance of substantive procedures is not necessary for an audit of internal control over financial reporting. However, while performing an audit of internal control, the auditor may review source documents (such as sales invoices) through tests of controls.

Question Regarding the Costs and Benefits of Internal Control

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?

As stated by the board in the introductory discussion to the proposed standard, "Internal control is not a "one-size-fits-all," and the nature and extent of controls that are necessary depend, to a great extent, on the size and complexity of the company." Although we concur that internal control may be implemented differently at smaller, mid-sized entities and are pleased that the proposed standard allows professional judgment in evaluating effectiveness, we have concerns with respect to the guidance provided by the Board on how internal control is implemented and on how the audit of internal control over financial reporting should be conducted at such entities.

The Board states (on page 6 of the introductory discussion to the proposed standard), "For a smaller, less complex company, the Board expects that the auditor will exercise reasonable professional judgment in determining the extent of the audit of internal control and perform only those tests that are necessary to ascertain the effectiveness of the company's internal control." We concur that an auditor should exercise professional judgment to perform only those procedures necessary. However, we believe that such judgment must be exercised on each engagement to audit internal control over financial reporting, regardless of the size and complexity of the entity. Small and medium-sized companies may have complex operations, while large, complex, multi-national companies may also have some simple operations. Accordingly, each company must establish and maintain necessary internal controls to prevent and detect misstatements on a timely basis, and the proposed standard imposes the minimum procedures that must be performed on all audits to evaluate the effectiveness of such controls.

The statement made above in conjunction with the guidance in Appendix E may be interpreted to infer that smaller, mid-sized companies can take a casual approach in implementing the necessary controls and in evaluating their effectiveness. Further, the auditor's standards for performance and evaluation appear to be lowered for such entities. The proposed standard requires the auditor 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. However, Appendix E discusses matters such as informal processes, monitoring controls performed by senior management, and the lack of documentation. This indirectly implies that there are certain internal control matters that the auditor can overlook when evaluating effectiveness for small and mid-sized companies.

In addition, Appendix E is currently being used as a supplement to the framework used by management to conduct its assessment, rather than as a guide on how the audit of internal control should be conducted for small and mid-sized companies. As the Committee of Sponsoring Organizations of the Treadway Commission's *Internal Control – Integrated Framework* already provides guidance on the application of the five internal control components to small and midsized entities, the proposed standard should not be used to modify or supplement such framework.

We recognize the PCAOB's well-intended efforts to provide guidance specifically related to smaller, mid-sized entities and to allow for professional judgment. However, due to the concerns expressed above, we believe that Appendix E should be deleted. Auditors of such entities would be able to apply the proposed standard in the absence of such guidance.

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.

It is not necessary to specify the level of competence and training needed to perform a specific audit procedure, generally or in the proposed standard. The interim standards (see AU Section

210, *Technical Training and Proficiency of the Independent Auditor)* appropriately describe the auditor's training, education, experience, supervision, review, and judgment with respect to performing an audit. As discussed in the interim standards, "The auditor charged with final responsibility for the engagement must exercise a seasoned judgment in the varying degrees of his supervision and review of the work done and judgment exercised by his subordinates, who in turn must meet the responsibility attaching to the varying gradations and functions of their work."

The proposed standard requires (in paragraph 31) the auditor to have competence in the subject matter of internal control over financial reporting in order to perform an audit of such. We believe this guidance is sufficient and appropriate. However, we suggest providing a reference to AU Section 210, which governs the technical training and proficiency of the auditor.

Questions Regarding Evaluation of Management's Assessment

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?

It is appropriate to require the auditor to evaluate the process management used to support its certifications and assertion to the auditor about the effectiveness of internal control over financial reporting. Although this arrangement places the auditor in the difficult position of having to make a judgment about the adequacy of management's efforts, we believe this is appropriate. We also believe it is important for the auditor to obtain his or her own evidence in order to provide an independent and objective opinion on management's assertion.

On the other hand, it may not be appropriate to require the auditor to disclaim an opinion where management has not fulfilled their responsibilities, as described in paragraphs 19 and 20. As previously discussed, the auditor's attestation is on management's assertion of the effectiveness of internal control over financial reporting. Even though management may not have performed adequate procedures to support their assertion, the auditor may be able to perform procedures to determine whether internal control over financial reporting is effective.

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

It is appropriate that the Board has provided criteria against which auditors can evaluate the adequacy of management's documentation to determine whether such documentation provides reasonable support for management's assessment. Not only does this criteria assist the auditor in determining whether management's documentation is adequate, it also assists management in determining the nature and extent of documentation that is necessary to support their assessment. Without such guidance, the auditor has no basis in evaluating the significance of the deficiency or the nature of the potential scope limitation.

When evaluating the adequacy of management's documentation, however, we believe that the auditor should also evaluate whether such documentation includes (a) the identification of where misstatements due to fraud or error could occur, (b) the specific controls that have been implemented to prevent or detect such misstatements, (c) the nature, timing and extent of the testing performed, and (d) the identification of the specific controls that were tested for operating effectiveness.

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?**

   It is appropriate to allow auditor judgment in evaluating whether management's inadequate documentation represents an internal control deficiency, a significant deficiency, or a material weakness in internal control. Because documentation may take many forms, can include a variety of information, and can vary depending on the size, nature, and complexity of the company, the severity of the deficiency is a matter of professional judgment, as is the evaluation of the adequacy of management's documentation.

   We recommend, however, that the Board clarify and revise the last sentence in paragraph 46, which states, "In evaluating the deficiency as to its significance, the auditor should determine whether management can demonstrate the monitoring component of internal control over financial reporting in the absence of documentation." This statement may have unintended consequences and could lead to arguments between management and the auditor as to the adequacy of management's efforts. It provides management a reason not to support their assessment through adequate documentation.

   We further recommend a cross-reference to paragraph 20, which discusses the issuance of a disclaimer when management has not fulfilled its responsibilities.

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?**

   As stated in paragraph 79, the objectives of a walkthrough are to:

   1. Confirm the auditor's understanding of the process flow of transactions.
   2. Confirm the auditor's understanding of the design of controls identified for all five components of internal control over financial reporting, including those related to the prevention or detection of fraud.
   3. Confirm that the auditor's understanding of the process is complete by determining whether all points in the process where misstatements related to each relevant financial statement assertion that could occur have been identified.
   4. Evaluate the effectiveness of the design of controls.
   5. Confirm whether controls have been placed in operation.

   We believe that all of the items listed above constitute what can be achieved through the performance of a walkthrough and other audit procedures, but does not necessarily represent the objectives of a walkthrough itself. We further believe that numbers 1 and 5 above constitute the objectives of a walkthrough, but numbers 2, 3 and 4 do not.

   Walkthroughs are performed to confirm or obtain an understanding of the process flow of transactions and the related controls and whether the documentation is accurate. While performing a walkthrough, the auditor can also determine whether such controls are placed in operation. Walkthroughs are not performed to evaluate the design of such controls. The auditor uses his or her professional judgment to evaluate design effectiveness based on all of the evidence obtained. Although a walkthrough may assist with obtaining information to perform such evaluation, it would rarely in itself be sufficient to conclude on design effectiveness.

Further, walkthroughs do not assist the auditor to confirm or obtain an understanding of the design of controls identified for all five internal control components. For example, the control environment does not relate to a specific transaction or event that can be traced through the information system. Finally, a walkthrough does not determine whether all points in the process where misstatements related to each relevant financial statement assertion that could occur have been identified.

Accordingly, we do not believe that it is necessary for the auditor to perform a walkthrough for all of the company's significant processes, including all types of transactions and events, whether they are recurring or unusual, on each audit of internal control over financial reporting. However, we do believe that there are certain circumstances where a walkthrough should be required to be performed by the auditor, as discussed in our response to question number 10.

We advise the Board not to overstate the benefits of a walkthrough. The "objectives" identified in the proposed standard can be achieved through the performance of other procedures, including inquiry, observation, and other tests of controls where the auditor reviews and compares supporting documents to the accounting records. We suspect such procedures are equally applicable to other processes also. So, while we agree that walkthroughs provide valuable evidence to the auditor, other procedures are sometimes available, which is why we urge that some judgment be afforded the auditor to choose the appropriate procedure to apply in the circumstances. For example, where the auditor performs tests of controls directly, he or she may not need to perform a walkthrough. However, where the auditor plans to rely on tests performed by others, the auditor may need to perform a walkthrough to obtain and/or confirm his or her understanding of the process flow of transactions.

Additionally, walkthrough procedures may differ for each audit. For example, in an initial audit, the auditor may need to perform more walkthrough procedures than in a continuing engagement. In a continuing engagement, the auditor may perform other procedures to achieve the objectives of the walkthrough and to update his or her understanding of the entity's processes and controls. In continuing engagements, the auditor may also alter the nature, timing, and extent of walkthrough procedures performed directly (or the use of walkthrough procedures performed by management and others) to introduce an element of unpredictability.

Finally, we recommend that the Board adequately define the term "significant process." We note that it always includes the period-end financial reporting process, which we agree with.

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?

Hopefully, the Board will agree with our response to question number 9. If so, we believe that it is appropriate to require the auditor to perform the walkthrough.

However, to achieve the objectives, as stated in the proposed standard, we believe the guidance provided by paragraphs 103 through 110 regarding the use of the work performed by management and others applies equally to walkthrough procedures and any other procedures performed by management and others. Accordingly, the auditor should be allowed to use his or her professional judgment in determining whether to use walkthrough procedures performed by management and others to alter the nature, timing, and extent of the tests of controls performed directly by the auditor to achieve the objectives of the walkthrough procedures. That said, however, the restrictions and limitations on the work performed by management and others should also be adhered to.

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?

    It is appropriate to require the auditor 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 auditor should obtain such evidence each year to support his or her opinion on management's assertion of the effectiveness of internal control over financial reporting. However, the sufficiency of the evidence obtained is a matter of professional judgment. Additionally, such evidence may differ from year to year, as the auditor alters the nature, timing, and extent of his or her procedures.

    As stated in paragraph 101, "The auditor also should vary from year to year the nature, timing, and extent of testing of controls to introduce unpredictability into the testing and respond to changes in circumstances. For example, each year the auditor might test the controls at a different interim period; increase or reduce the number and types of tests performed; or change the combination of procedures used." A particular area where testing may vary significantly is over information technology systems. As technology operates in a systematic manner, the auditor may evaluate and test general computer controls, including program changes and security access, while performing only limited procedures over the specific program controls.

    We acknowledge, however, that auditing is a continuous process. While the auditor uses his or her experience and knowledge of effectiveness from previous years to alter the nature, timing and extent of test of controls, he or she does not necessarily rely on the audit evidence obtained from such prior periods as the sole evidence for the current year's opinion. Further, the auditor may be placed in a unique situation where the period between opinions is less than a year. For example, the auditor may be asked to provide an opinion on the effectiveness of internal control over financial reporting as of an interim date or the company may decide to change its year-end for reporting purposes. We view such circumstances as tests performed at an interim date, where the opinion on the previous period constitutes the interim testing date. Accordingly, the auditor determines what additional evidence to obtain concerning the design and operation of the controls for the remaining period and considers significant changes in controls from the "interim" date to the "as-of" date. The auditor also considers controls that may only operate during or apply to the interim or annual periods. Where a change in the company's year-end occurs, the auditor should only be required to perform an audit of internal control when audited financial statements are required to be presented.

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?

    As the auditor is ultimately responsible for his or her opinion, he or she should be allowed to apply professional judgment in determining whether to use the work of management and others to alter the nature, timing and extent of his or her procedures to obtain sufficient competent evidence to render the report. The auditor should never be "required" to use the work of management and others, as the independence and objectivity of the individuals that performed such work may have been impaired. Additionally, such individuals may not be deemed competent with respect to internal control.

Our responses to questions 13 through 16 provide additional comments on the extent the auditor should be permitted to use the work of management and others.

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

The three categories of controls and the extent to which the auditor may rely on the work performed by management and others need some clarification. We believe that it is appropriate to prohibit the use of the work performed by management and others when evaluating controls that are part of the control environment, controls over the period-end financial reporting process, and controls that have a pervasive effect on the financial statements, due to the extensive judgment involved with such evaluation and the impact on the nature, timing and extent of the auditor's procedures. It also is appropriate to limit the use of the work of management and others in the areas addressed by paragraph 105. Such matters also involve a significant amount of judgment, but do not ordinarily have a pervasive effect on the auditor's procedures.

With respect to the third category, controls over routine processing of significant accounts and disclosures, we suggest that the Board clarify the phrase "without specific limitation." As written, it may be misinterpreted to mean that the auditor does not have any responsibilities and can rely on the work of others without performing any additional procedures. Although the auditor can use the results of tests performed by management and others, we believe that the auditor must still reperform some of the tests performed by others and use such tests to alter the nature, timing and extent of procedures he or she performs directly. However, reperforming more of the procedures performed by management and others may significantly reduce such direct procedures.

In regards to the first category where the use of the work performed by management and others is prohibited, we recommend that the Board view information technology general controls as those where the auditor's use of the work of management and others is limited. Such controls do not ordinarily involve extensive judgment.

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?

The proposed standard gives appropriate and adequate recognition to the work of internal auditors. It is also consistent with existing interim standards (AU Section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*) with respect to evaluating internal audit's competence and objectivity in determining how internal audit's work may affect the audit of internal control over financial reporting. Such existing literature provides guidance to the auditor on evaluating internal audit's competence and objectivity and in evaluating the relevancy of their work. As such, we believe that it would be appropriate and necessary to include a reference to AU Section 322 within paragraph 108, even though the proposed standard provides a reference to such existing literature in Appendix B.

The proposed standard should not, however, add additional emphasis on the use of internal audit's work. Although the auditor may be able to use their work to a greater extent than the work performed by other personnel, internal audit is a part of the company's monitoring component of internal control. Accordingly, to place more emphasis on the use of internal audit's work may inappropriately reduce the work directly performed by the auditor.

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)?

The auditor uses the work performed by management and others to alter the nature, timing and extent of his or her procedures. When using the work of management and others, the auditor should perform tests to evaluate the quality and effectiveness of the work performed. The tests performed by the auditor to make this evaluation depend on the extent of the effect of the work of management and others on the procedures performed directly by the auditor. When performing such tests, the auditor may either (a) reperform some of the work performed by management or others, or (b) examine the work performed, perform similar tests, and compare such tests to the results of the work performed by management and others.

The combination of the procedures performed to test the work performed by management and others and the tests performed directly by the auditor are a matter of professional judgment and together should provide sufficient competent evidence to support the auditor's opinion. Accordingly, it is appropriate to allow flexibility in determining both the extent of reperformance of the work of management and others and the nature, timing and extent of procedures performed directly by the auditor. The proposed standard should not mandate that the auditor reperform a certain level of work, including reperforming tests of all significant accounts or reperforming every test performed by others that the auditor intends to use.

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?

As stated previously, the auditor is ultimately responsible for the opinion expressed. As such, it would be inappropriate for the auditor to obtain most of his or her evidence by using the work performed by management and others. On an overall basis, the auditor should perform enough procedures directly to be able to make his or her own conclusions. That said, however, the benchmark for the amount of work that is required to be performed directly by the auditor is a matter of professional judgment.

We believe that the Board intends the principal evidence requirement to apply on an overall basis, rather than on a relevant assertion or significant account basis. Accordingly, we suggest that the Board clarify its intents in the proposed standard.

Questions Regarding Evaluating Results

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?

We acknowledge the Board's efforts to clarify and narrow the definitions of a significant deficiency and a material weakness, to provide detailed examples on the application of such definitions, and to list the matters that are strong indicators that a material weakness exists. Altogether, this guidance should promote consistency in evaluating whether an internal control deficiency is a significant deficiency or a material weakness. Nevertheless, such evaluations involve extensive judgment, and each individual may conclude differently as to the severity of a deficiency.

With respect to the definitions of a significant deficiency and a material weakness, however, the discussion of "likelihood" should be enhanced and clarified. The proposed discussion of likelihood could be read to allow a conclusion that a deficiency is not a material weakness because it has never been a problem in the past. For instance, management can argue that there is a "remote likelihood" that a material misstatement will not be prevented or detected in the future because a material misstatement as it relates to a particular deficiency has never occurred. As such, language should be added to state that the absence of a past material error in financial reporting due to a deficiency does not mean that likelihood is low enough to keep a deficiency from being a material weakness. The definition of material weakness is focused on what could happen and is not limited to what has happened.

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?

As stated in our response to question number 17 above, the examples in Appendix D are useful and should assist in promoting the consistency with which internal control deficiencies are evaluated. It would be helpful, however, if one or more examples were added dealing with deficiencies relating to information technology systems or deficiencies dealing with controls over operations or compliance with laws and regulations that could materially affect financial reporting. Also, with respect to the safeguarding of assets, it would be very useful to have examples that illustrate deficiencies that are financial reporting in nature, deficiencies that relate to the assertions about safeguarding that management is required to make under Section 404, and deficiencies in safeguarding that are not within the scope of financial reporting and Section 404 assertions.

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

The auditor's objective in an audit of internal control over financial reporting is to express an opinion on management's "assessment" of effectiveness. Where significant deficiencies, either individually or in the aggregate, constitute a material weakness in internal control, management is precluded from concluding that internal control over financial reporting is effective and the auditor must express an adverse opinion. Consequently, in order for the auditor to achieve his or her objectives, he or she should be required to evaluate the severity of all identified internal control deficiencies. Otherwise, the auditor may inappropriately conclude that internal control over financial reporting is effective.

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?

We believe that the auditor should communicate all identified significant deficiencies and material weakness in writing. We do not believe it is appropriate to require the auditor to communicate in writing internal control deficiencies that are below the level of a significant deficiency. Any oral or written communications of such matters should be made at the discretion of the auditor. For example, the auditor may choose to communicate deficiencies that management may not be aware of. As with the reporting of misstatements that come to the auditor's attention during an audit of financial statement, there is no need to require the reporting of every minor internal control deficiency that comes to the auditor's attention. However, the auditor may report all deficiencies noted if requested to do so by management or the audit committee.

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

The matters that the Board has classified as strong indicators that a material weakness exists are appropriately classified as such. These matters clearly fall within the definition of a significant deficiency, where there is more than a remote likelihood that a misstatement that is more than inconsequential in amount will not be prevented or detected. Such misstatements may be material to the financial statements and therefore, these matters could also constitute a material weakness.

There may be circumstances where the auditor identifies a material weakness in internal control over financial reporting in the current period that was not initially identified by the company's internal control evaluation and testing process. We believe that this is, at a minimum, a significant deficiency and also a strong indicator that a material weakness exists, even if management subsequently corrects the weakness. As such, we suggest that the Board add this matter to paragraph 126 as a strong indicator of a material weakness.

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?**

The proposed standard states, "The company's audit committee plays an important role within the control environment and monitoring components of internal control over financial reporting." We agree with this statement. Thus, the audit committee falls within the bounds of internal control over financial reporting, and the auditor has a responsibility to evaluate the effectiveness of the audit committee's oversight. Therefore, it is appropriate to require the auditor to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting as a component of internal control, but not separate from its effectiveness as it relates to the overall internal control. There are certain factors that the Board proposes to require the auditor to evaluate for which the auditor does not possess the appropriate qualifications. Such factors may not be necessary for the auditor's evaluation of the company's internal control over financial reporting.

For example, we believe that the auditor's training and experience provide a basis for evaluating the clarity with which the audit committee's responsibilities are articulated and understood by the audit committee and management and the audit committee's involvement and interaction with the external and internal auditor. However, such training and experience is insufficient to evaluate the audit committee's independence and their compliance with applicable listing standards. We believe such matters involve legal determinations that are beyond the auditor's professional competence and are not necessary to evaluate the company's internal control over financial reporting.

In the context of an audit of internal control over financial reporting, we also question the emphasis placed on the evaluation of the effectiveness of the audit committee's oversight. Effective oversight does not necessarily imply that internal control over financial reporting is effective. We believe that the audit committee's oversight is one element of the control environment (a very important one) and monitoring components of the company's internal control. Accordingly, the standard should indicate that as with any other control where a deficiency exists, the auditor evaluates the severity of the deficiency and the impact on the conclusions reached.

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

As auditors, we generally are not privy to the entire conduct of the audit committee. Further, the evaluation of the effectiveness of the audit committee's capabilities, competence, and oversight processes requires extensive judgment on the part of the auditor and, as described in our response to question number 22, certain matters related to those considerations are beyond the realm of the auditor's expertise and also may not be relevant to the auditor's consideration of the effectiveness of the company's internal control over financial reporting.

The auditor should, however, be able to effectively carry out his or her responsibility to evaluate the effectiveness of the audit committee's oversight as it relates to the evaluation of the company's internal control over financial reporting, even though the auditor may not be able to separately evaluate the effectiveness of their oversight as a whole. The auditor evaluates the effectiveness of the audit committee's oversight primarily through the appropriate use of inquiry and observation techniques focused on the audit committee's involvement with financial reporting matters. For example, the auditor focuses on metrics such as how often the audit committee meets, the audit committee's expectations, and their involvement with the risk management process, rather than evaluating their independence and compliance with external requirements.

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?

The auditor should not be required to withdraw from the audit engagement in response to <u>any</u> identified material weakness. The presence of a material weakness, including a material weakness where the audit committee's oversight is ineffective, does not necessarily impose a limitation on the scope of the engagement. Accordingly, whether to withdraw should remain a judgment made by the auditor. Further, it would not be in the public interest to require the auditor to withdraw from the engagement due to ineffective audit committee oversight.

Questions Regarding Forming an Opinion and Reporting

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?

When one or more material weaknesses in internal control over financial reporting exist, management is not permitted to conclude that internal control over financial reporting is effective. In such circumstances, we concur with the Board's conclusions that (a) management must report that internal control is not effective, (b) the auditor's reporting model must be consistent with managements reporting model, and (c) the issuance of a qualified "except for" conclusion by management or the auditor is not acceptable. As such, it is appropriate that the existence of a material weakness would require the auditor to express an adverse opinion about the effectiveness of the company's internal control over financial reporting.

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

We do not believe there are any circumstances where a qualified "except for" opinion would be appropriate. This would require the auditor to evaluate the severity of a material weakness, in essence creating another category of deficiencies.

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?

With the public interest in mind, we agree with the Board's position to require the auditor to opine directly on internal control effectiveness when a non-standard report is to be issued. Although both opinions would be appropriate, we believe that this approach will eliminate potential confusion relating to the auditor's opinion on the effectiveness of internal control over financial reporting.

We have concerns, however, with respect to the overall reporting model, specifically relating to the identification of the financial statements to which the opinion applies. The introductory paragraph of the independent auditor's report states the following:

> "We have audited management's assessment, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify criteria, for example "criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organization of the Treadway Commission (COSO)."]*. W company's management is responsible for its assessment about the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment based on our audit."

From a user perspective, we suggest that the scope of the term "financial reporting" be clearly delineated in management's assertion and the auditor's report. We believe that this generic term could be interpreted to extend to all financial reporting that occurs on the "as of" date. For example, management's assertion on internal control effectiveness over financial reporting of a consolidated entity could be interpreted by the user community to include: financial statements issued by each of the subsidiaries in accordance with generally accepted accounting principles or another comprehensive basis of accounting, and reporting of financial information at a consolidated and subsidiary level to government agencies, such as the Internal Revenue Service. Accordingly, we suggest that the Board clearly define the term "internal control over financial reporting" and limit it to the specific financial statements covered by the report, for example, the financial statements required to be filed in accordance with generally accepted accounting principles and SEC rules and regulations under the Securities Exchange Act of 1934. For example, the introductory paragraph may be worded as follows:

> We have audited management's assertion, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 20X3 in the Company's financial statements filed with the Securities and Exchange Commission, based on [*Identify criteria, for example "criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organization of the Treadway Commission (COSO)."]*.

Questions Regarding Auditor Independence

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

Although we believe the Board should provide specific guidance and adopt certain rules on independence and internal control-related matters, as indicated in our response to question number 29, the Board should not provide them within this standard. We suggest that independence matters not reside directly in the auditing and other attest standards. Such matters should exist independently, through separate independence standards or the SEC's rules and regulations.

An auditor is required to adhere to all requirements imposed by the PCAOB's Auditing and Related Professional Practice Standards and those imposed directly by the SEC. Accordingly, it is not necessary to repeat such requirements in multiple locations (and can even be burdensome for the regulators to maintain). A reference to the relevant standards, rules and regulations is sufficient and does not alter the auditor's responsibilities. Additionally, it promotes compliance with the standards, rules and regulations, as such information is contained within the related subject matter.

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

We believe that the Board should adopt Grant Thornton's position on independence in regards to internal control-related services by the external auditor. Our position is expressed in the following excerpt from a testimony given by Ed Nusbaum, Grant Thornton's Chief Executive Officer, on September 23, 2003, before a full committee hearing of the U.S. Senate Committee on Banking, Housing and Urban Affairs, the subject: "The Implementation of the Sarbanes-Oxley Act and Restoring Investor Confidence."

> "…The degree of an auditor's independence is driven by the separation between management (which produces the financial information) and the users of the information provided by management. The standard for independence is heightened as that separation increases. We firmly believe that the auditors of publicly held companies must hold themselves to the highest possible standard of independence.
>
> For this reason, Grant Thornton will not accept engagements to document, evaluate or design our public audit clients' internal controls, including engagements to document existing controls, or to perform evaluations of existing controls that management uses to support their conclusions regarding the effective design of those controls. To do so, we feel, is a conflict of interest. Instead, as auditors, we will audit the internal controls as designed, documented and evaluated by management, in accordance with the provisions of the Act."

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?

The differing levels of responsibility as they relate to management's quarterly and annual certifications are appropriate and are consistent with the current reporting model. For example, the accountant performs a review of the company's interim financial information and management's quarterly 302 certifications (as it relates to the disclosure of any material change in internal control over financial reporting during the period), while he or she performs an audit of the company's annual financial statements and management's assertion of the effectiveness of internal control over financial reporting. However, we do believe that the responsibility for the accountant to determine whether significant changes in internal control over financial reporting may introduce significant deficiencies or material weaknesses in the design of internal control over financial reporting discussed in paragraph 186 is inconsistent with the objective of a review of interim financial information.

The objective of a review of interim financial information pursuant to AU Section 722, *Interim Financial Information,* is to provide the accountant with a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information for it to conform with generally accepted accounting principles. A review consists principally of performing analytical procedures and making inquiries of persons responsible for financial and accounting matters, and does not contemplate tests of accounting records through inspection, observation or confirmation. We believe that paragraph 186, as currently written, creates a responsibility that is inconsistent with the objective of a review of interim financial information. We suggest the following language as an alternative:

> "If there have been significant changes in the design or operation of internal control over financial reporting, perform procedures to obtain sufficient knowledge to understand the effect of such changes on internal control as it relates to the preparation of interim financial information and inquire of management whether such changes may introduce significant deficiencies or material weaknesses in the design of internal control over financial reporting."

AU Section 722 addresses the matters discussed in paragraphs 185 through 188. We urge the Board to consider revising this section in light of AU Section 722, and in lieu of providing such guidance in the proposed standard, amend AU Section 722 for the requirements of Section 302 and make reference to the guidance in AU Section 722 in the proposed standard. We also urge the Board to use "accountant" rather than "auditor" when discussing interim reviews in paragraphs 185 through 188 to be consistent with AU Section 722.

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

Please see our response to question number 30. The scope of the accountant's responsibility for quarterly disclosures should be consistent with the accountant's responsibility for material misstatements of interim financial statements under AU Section 722.

Appendix B – Specific Paragraph-Level Comments

The following describes additional concerns and offers other substantive comments and/or suggestions relating to specific paragraphs.

- **Footnote 1** – Where the PCAOB believes that there will be any need or request for an audit of internal control over financial reporting other than those mandated by Section 404 of the Sarbanes-Oxley Act, they should maintain a standalone standard for such attestation engagement. Please see our response to question number two.

- **Paragraph 7** - A deficiency in operation is described, among other things, as one where a person performing the control does not possess the necessary authority or qualifications to perform the control effectively. This is an element of design, as well as operation. For example, assigning the appropriate individual to perform a control (e.g., segregation of duties) relates to design. Whether the assigned individual performed the control and how well that person performed the control relates to operation. We suggest that the Board revise the definitions of a design deficiency and an operating deficiency, accordingly.

- **Paragraphs 21 and 22** – We believe that the concepts in these paragraphs need clarification. These paragraphs should clearly state that materiality, as it is described herein, relates to evaluating the severity of internal control deficiencies to determine whether they are significant deficiencies and material weaknesses, rather than used for purposes of performing the audit of internal control over financial reporting. In addition, the proposed standard should not suggest that we conduct the audit at a lower level of materiality at the individual account-balance level. Paragraph 61 describes that an account is significant if there is more than a remote likelihood that the account could have a material effect on the financial statements. Accordingly, the audit would be planned in consideration of materiality at the financial statement level.

- **Paragraph 36** - The last sentence of this paragraph states "Inquiry of management and employees is the beginning point for obtaining an understanding of internal control over financial reporting, but inquiry alone is not adequate for reaching a conclusion on any aspect of internal control over financial reporting effectiveness." We believe that the word "any" should be deleted. In many instances, inquiry may be the only procedure that can be performed to support the effectiveness of a "single" control. Inquiry alone is not sufficient to support our opinion on management's assertion, but may be sufficient to support a conclusion that certain controls are operating effectively.

- **Paragraph 61** - The definition of a significant account would seem to allow the auditor some latitude in determining which accounts will require testing, for example limiting work to those where a material misstatement could exist rather than requiring testing for either quantitative or qualitative materiality. This approach, however, seems to be at odds with the example in B18. For instance, if the auditor were to conclude that the likelihood of a misstatement of the property, plant and equipment account is remote in the example presented, we would argue that we do not need to test controls over that account solely on the basis of the materiality of the balance to the financial statements.

- **Paragraph 74** – This paragraph lists items that should be evaluated by the auditor when identifying controls to test. With respect to the third bullet, we recommend replacing the phrase "whether more than one control achieves a particular objective" with the phrase "whether more than one control is necessary to achieve a particular objective." In regards to the fourth bullet, the auditor should not consider the nature and extent of tests performed by management and others when determining which controls to test. The auditor should make his or her own judgment as to which controls should be tested and then determine the nature, timing and extent of the tests to be performed directly (or tests to reperform the work of management and others). With respect to the very last item, we do not believe that the complexity of the control is a consideration. Processes and systems may be complex; however, individual controls are quite simple.

- **Paragraph 88** – Please refer to our comments for paragraph7 regarding the definitions of a design deficiency and an operating deficiency.

- **Paragraph 92** – This paragraph states, "Because inquiry alone does not provide sufficient evidence to support the operating effectiveness of a control, the auditor should perform additional tests of controls." Please see our comments relating to paragraph 36. Inquiry may be a sufficient procedure for evaluating "a" single control.

- **Paragraph 136** – This paragraph states, "To assess control risk for specific financial statement assertions at less than maximum, the auditor is required to obtain evidence that the relevant controls operated effectively during the entire period covered by the company's financial statements." We disagree with this statement. The auditor should test controls over the period in which the controls are being relied upon, which may not be the entire period covered by the financial statements. Other substantive procedures can be performed to cover the "stub-period." Together, such procedures would be sufficient to reduce audit risk to an appropriately low level.

- **Paragraph 139** – We suggest defining the term "significant risk," as it is not currently defined in the interim standards.

- **Paragraph 140** – We suggest the following revision: "For this reason, substantive analytical procedures **alone** are not well suited to detecting fraud." Perhaps there are situations where substantive analytical procedures alone may not be effective; however, we disagree that they are never effective as the statement implies. For example, the performance of disaggregated analytical procedures over revenue may assist in detecting fraud or potential fraud.

- **Paragraph 143** – This paragraph requires the auditor to evaluate his or her findings from substantive procedures performed in the audit of the financial statements and their effect on the effectiveness of internal control over financial reporting. It also lists matters the auditor should include when performing such an evaluation. We believe the requirement to evaluate **all** findings is unnecessary and improperly excludes the auditor's professional judgment and consideration of materiality and the significance of the finding. In addition, certain matters listed do not represent findings from substantive procedures (e.g., risk evaluations), and the impact on internal control effectiveness is not necessarily apparent from some of the items presented (e.g., findings with respect to related party transactions). Accordingly, we urge the Board clarify its intents with respect to this paragraph and eliminate the requirement to evaluate **all** findings.

- **Paragraph 145** – The proposed standard requires the auditor to document "the process used to determine significant accounts, classes of transactions, and disclosures, including the determination of the locations or business units at which to perform testing." We suggest that the Board clarify what is meant by this documentation requirement, including what the Board expects to be documented. For example, could the process be a firm's methodology?

- **Paragraphs 146 & 147** – This paragraph states "The auditor also should document the effect of a conclusion that control risk is other than low for any relevant assertions for any significant accounts on his or her opinion on the audit of internal control over financial reporting." We suggest that the Board clarify the documentation requirements and the auditor's control risk assessments. For example, the matters described in paragraph 146 may alter the control risk assessment for the audit of the financial statements. By definition, control risk is the risk that a material misstatement in an assertion will not be prevented or detected on a timely basis by internal control policies or procedures. Accordingly, with respect to the audit of internal control, we believe that only a material weakness precludes the auditor from assessing control risk at low. As such, the items in paragraph 146 would preclude the issuance of an unqualified opinion on the effectiveness of internal control over financial reporting.

- **Paragraph 163** – As indicated in our response to question number 21, where the auditor identified a material weakness that was not identified by management, this in itself may be a material weakness. Accordingly, clarification of the second bullet point may be necessary.

- **Paragraph B15** – The last sentence of this paragraph states "The evaluation ordinarily would not extend to controls at the equity method investee." We suggest that the PCAOB delete the word "ordinarily," as it extends beyond the scope of the auditor's responsibilities.

- **Example B-1** – The extent of the expected information technology testing is a concern; it would appear that an information technology expert will need to be involved on all audits for all information technology processes that the auditor relies on to independently verify that there were no changes made in the system, or that the system was put in operation on the date the client maintained. Inquiry of the company's information technology manager will be insufficient in and of itself to audit the changes to the system. Nor would we be able to rely on a change log kept by the information technology manager, as it would be subject to alteration/manipulation.

Appendix C – Other Recommendations

The following represent other recommendations.

- **Footnote 1** – We suggest that in lieu of stating the "standard does not apply," stating that the "standard applies to a limited extent," when an auditor audits the financial statements but does not audit a company's internal control over financial reporting.

- **Paragraph 5** – In the first sentence, we recommend replacing the word "operated" with the word "operating" or replacing the word "is" with the word "was."

- **Footnote 9** – The Board may also choose to add a reference to Staff Accounting Bulletin No. 99, *Materiality*.

- **Paragraph 18** – We suggest that the Board clarify the level of assurance provided by management versus that provided by the auditor. Specifically, an explanation as to why the auditor does not provide the "same assurance" as management would be helpful.

- **Paragraph 24** – With respect to the controls that address the risk of fraud, we agree that the auditor should pay particular attention to the control environment; however, given this requirement is presumptively mandatory, we suggest the Board clarify their intent with respect to the term "special emphasis."

- **Paragraph 27** – We suggest adding a cross-reference to where the phrases "relevant financial statement assertions" and "significant accounts and disclosures" are defined.

- **Paragraph 39** – This paragraph describes certain matters the auditor should evaluate when planning the audit to determine the affect on his or her procedures. We suggest adding a cross-reference to paragraph 101, which discusses altering the nature, timing and extent of testing to introduce an element of unpredictability and to respond to changes in circumstances.

- **Paragraphs 48-50** – We recommend linking the term "specific controls" to the requirement to evaluate controls over "relevant assertions and significant account balances."

- **Paragraph 113** – The schedule of passed adjustments and the adjustments recorded by management are an important element to consider when forming an opinion on internal control over financial reporting. Accordingly, a specific mention of such is appropriate within this paragraph.

- **Paragraph 157** – This paragraph discusses that the date of the auditor's report on the financial statements and the date of the auditor's report on the audit of internal control should be the same. We suggest the Board consider the impact of dual-dating for subsequent events. We believe that a dual-date for a subsequent event relating to either opinion should not impact the date of the other report.

- **Paragraph 168 –** The SEC staff has provided certain guidance with respect to meeting the requirements of a principal auditor for a financial statement audit. We suggest the Board clarify such requirements and their applicability to an audit of internal control over financial reporting.

From: Grinham, Jim
Sent: Wednesday, October 15, 2003 3:33 PM
To: Comments
Subject: PCAOB Rulemaking Docket Matter No. 008

The proposed auditing standard would limit or eliminate the External Auditors ability to rely on the work performed by management in the area of general (aka. pervasive) IT controls, as described in the briefing paper as well as the proposed Standard (page A-37, # 103).

Briefing Paper states...."That is, the standard would establish certain categories of work that the auditor must perform, such as work related to company-wide anti-fraud programs and controls and work related to other controls that have a pervasive effect on the company, such as controls over the company's electronic data processing".

Proposed Standard states....There are a number of areas in which the auditor should not use the results of testing performed by management and others, including;...Controls that have a pervasive impact on the financial statements, such as certain information technology general controls on which the operating effectiveness of other controls depend.

This exclusion of general IT controls from the scope of testing that can be relied upon makes absolutely no sense. Of the many types of controls that will require testing, general IT controls are in fact more easily substantiated and replicated than most. General IT controls have been the one area in which many if not most companies have instituted a "controls framework" for establishing and evaluating controls. The types of controls (access controls, program change controls, disaster recovery controls, etc.) requiring testing in response to Sarbanes-Oxley Section 404 are the same as those that we have been testing for years. While our situation may be different than others, the amount and depth of IT general controls testing performed internally has always far surpassed the degree of testing performed by external auditors. Why the experience and knowledge we have gained over time regarding IT general controls would be dismissed in formulating an opinion regarding the adequacy of these controls seems entirely contrary to the intent of Section 404.

In our specific situation, which is comprised of some 50 strategic business units and over 20 different ERP systems, it would appear in the worst case impractical if not impossible for the external auditors to test general IT controls across the enterprise and in the best case, potentially prohibitive from a fees standpoint.

I would strongly urge you to reconsider this matter from a practicality standpoint and consider the fact that the auditors' ability to attest to the adequacy of general IT Controls and their pervasive effect may well be
enhanced by their ability to rely on the work performed by management.

Jim Grinham

Guidance SOFTWARE | The Leader in Computer Forensics and Incident Response Solutions

November 14, 2003

VIA EMAIL

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 8

Dear Sirs or Madams:

These comments are submitted on behalf of Guidance Software, Inc. in response to the Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* (the "Proposed Standard") contained in PCAOB Release No. 2003-017 (the "Release") (PCAOB Rulemaking Docket Matter No. 008). The Proposed Standard, if adopted, would be the standard on attestation engagements referred to in Section 404(b) and Section 103(a)(2)(A) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley").

Guidance Software applauds the PCAOB as it continues its efforts to re-establish the independence of the auditing profession and improve the quality of audits, and thus their utility to investors. The Proposed Standard, however, falls short in addressing the auditor's role in preventing, detecting, and responding to fraud. Since a lack of effective internal controls enables fraud, and the result of fraud is often an improper use or disposition of assets (and is thus covered by the definition of "internal control over financial reporting"), the audit of internal control over financial reporting should address a company's policies and practices aimed at discouraging and responding to fraud.

Although the Release sets forth thirty-one specific questions, on topics ranging from an integrated audit to auditor's independence, the PCAOB has not set forth any question concerning the issue of fraud. The entirety of the PCAOB's commentary concerning fraud, in a twenty-five-page letter, consists of one paragraph, which is set forth below:

> **Fraud Considerations in an Audit of Internal Control Over Financial Reporting**
>
> Strong internal controls provide better opportunities to detect and deter fraud. For example, many frauds resulting in financial statement restatement relied upon the ability of management to exploit weaknesses in internal control. To the extent that the internal control reporting required by Section 404 can help restore investor confidence by improving

> the effectiveness of internal controls (and reducing the incidence of fraud), the auditing standard on performing the audit of internal control over financial reporting should emphasize controls that prevent or detect errors as well as fraud. For this reason, the proposed standard specifically addresses and emphasizes the importance of controls over possible fraud and requires the auditor to test controls specifically intended to prevent or detect fraud that is reasonably likely to result in material misstatement of the financial statements.[1]

The PCAOB has glossed over the central point of Sarbanes-Oxley: that public companies must engage in effective self-policing to combat internal corporate fraud. Sarbanes-Oxley represented the Congressional response to "the shenanigans . . .that ha[d] been going on in corporate America"[2] such as the Enron debacle.[3] Thus, Sarbanes-Oxley was enacted to protect investors by combating corporate crime and improving corporate governance.[4] One of the central themes underlying Sarbanes-Oxley is that public companies need to institute and maintain adequate internal controls, which must include "controls related to the **prevention, identification and detection of fraud**."[5] (Emphasis added). As many commentators have noted, Sarbanes-Oxley requires companies to implement extensive corporate governance policies to prevent and to respond timely to fraudulent activity within the company.[6] For example, Sarbanes-Oxley expressly requires publicly traded companies to create anonymous hotlines for the reporting of fraud, it requires executives to certify that their financial statements are accurate, and it provides additional protections for employees of public companies who report fraud. The inclusion of a requirement for an internal control audit was an effort to have the auditing profession, instead of shredding evidence as in the Andersen case, directly involved in the effort to prevent, identify, and discover fraud. Clearly, the requirement that a financial statement audit encompass controls that address or mitigate fraud risk, as required by AU sec. 316, *Consideration of Fraud in Financial Statement Audit*, proved ineffective prior to Sarbanes-Oxley, at least in the eyes of Congress. Thus, a new audit requirement was instituted to have auditors conduct a separate audit of a company's internal controls.

The Section 404 requirement of effective internal controls encompasses more than mere accounting practices. In June 2003 the SEC issued its final rules under Section 404 of Sarbanes-Oxley. The SEC noted that "internal control is a broad concept that extends beyond the accounting functions of a company."[7] Under the SEC's definition of "internal control over financial reporting," a definition which the Release purportedly adopts,[8] the internal controls process must include policies and procedures that:

> Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the [company's] assets that **could have** a material effect on the financial statements.[9]

The definition is crystal clear: internal controls over financial reporting must include those controls designed to prevent or detect activities such as insider trading and other internal financial fraud, theft of intellectual property, large-scale misappropriation of customer information, or other similar losses that "could have" a material effect on the financial statements. The Proposed Standard, however, narrows the "safeguarding of assets" function of internal controls to "protection only against losses arising from intentional and unintentional misstatements in processing transactions and handling the related assets."[10] As noted above, however, safeguarding of assets is intimately linked to the prevention and detection of fraud; the occurrence of fraud often leads directly to the misappropriation or destruction of a company's assets. Note that the COSO Framework recognizes that one of the "temptations" for employee fraud is "nonexistent or ineffective controls," as well as "high decentralization that . . . reduces the chances of getting caught."[11] Thus, in order to prevent employee fraud, or unauthorized acquisition, use or disposition of a company's assets, the company should have in place effective controls that increase the likelihood of getting caught. In discussing fraud, however, the Proposed Standard restricts the review of controls "intended to address the risks of fraud that are **reasonably likely** to have a material affect on the company's financial statements."[12] As a result, a failure of controls against fraud that "could have," but is not "reasonably likely to have," a material affect on the company's financial statements is written out of the Proposed Standard. There is no justification for this narrow focus. Rather, the Proposed Standard should focus on controls to fight fraud (which leads to unauthorized acquisition, use or disposition of the company's assets) that **could have** a material effect on the financial statements.

A pair of hypotheticals highlights the shortcomings of the Proposed Standard:

> 1) Assume a company in which a senior executive who has access to material, nonpublic information is facilitating a friend's trading in the company's stock based on that information, in violation of the company's internal policies and the securities laws, by using an instant messaging service. Assume further that the company has failed to implement available technology that would allow it to capture the relevant evidence concerning the rogue employee's activities, and thereby enforce its policies, and refer the case to law enforcement.[13] Finally, assume that public knowledge of this executive's activities would materially harm the company by causing it to defend itself from regulatory investigations and shareholder suits. In an audit under the Proposed Standard, the Company's "nonexistent or ineffective controls," to use the COSO language, would be unlikely to be unmasked, since the controls in question would not govern "intentional and unintentional misstatements in processing transactions." Certainly, if the auditors uncovered the executive's fraud, it would result in at least a significant deficiency under Section 126 of the Proposed Standard. However, the auditing profession's track record in uncovering executive fraud is not comforting. It would be far better for auditors to focus on looking for and demanding effective controls that increase the

likelihood of catching employee malfeasance, thereby helping prevent employee fraud in the first place.

2) Assume an entertainment company that has valuable intellectual property, both in already released films, and in films currently being produced. Assume further that if one of the pre-released films were to transmitted by a rogue employee to a file-sharing website prior to the scheduled launch of the film, that the company would suffer material financial harm. Finally, assume that the company has failed to install readily available controls to detect the rogue employee's unauthorized disposition of this important company asset. Under the definition of "internal control over financial reporting," the hypothetical entertainment company has a problem (whether defined as an internal control deficiency, a significant deficiency, or a material weakness) – its internal controls do not "provide reasonable assurance regarding prevention or timely detection of unauthorized . . . disposition of . . . assets that could have a material effect on the financial statements." Under the Proposed Standard, however, the auditors would have nothing to say about this hypothetical company's grievous lack of internal controls, because the controls in question would not govern "intentional and unintentional misstatements in processing transactions."

COSO specifically recognizes the risks of internal wrongdoing: "Former or disgruntled employees can be more of a threat to a system than hackers."[14] Indeed, "the assessment of risks not only influences the control activities, but may also highlight a need to reconsider information and communication needs."[15] The Proposed Standard does nod towards the broader COSO approach by noting that "[t]he auditor should identify all controls that could materially affect financial reporting, including controls that focus primarily on the effectiveness and efficiency of operations or compliance with laws and regulations and which also have a material effect on the reliability of financial reporting."[16] The Proposed Standard, however, should focus more on those controls that can safeguard the company's assets from fraud or other unauthorized use or disposition. For example, Section 126 of the Proposed Standard sets forth specific circumstances that "should be regarded as at least a significant deficiency and [are] a strong indicator that a material weakness in internal control over financial reporting exists."[17] In addition to the items listed, there should be added:

- Fraud prevention, detection and/or response programs and controls are ineffective.[18]
- Controls to protect the company's assets from unauthorized acquisition, use or disposition are ineffective.

As noted above, Section 126 of the Proposed Standard lists "[i]dentification of fraud of any magnitude on the part of senior management." Certainly, if fraud is identified, that is indicative

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of a serious control issue. The more fundamental point, however, is that the lack of effective controls to prevent, detect, and respond to fraud is a serious control issue, whether or not any fraud is identified at the time of the audit. Moreover, it is a control issue that ultimately impacts the accuracy and quality of the company's financial reporting.

In sum, internal fraud and insider malfeasance in corporate America caused widespread harm to investors and the overall economy, leading directly to the passage of Sarbanes-Oxley. Because the lack of adequate controls to deter, prevent, and respond to such fraud creates an unreasonable risk of such fraud occurring, which very well could impact the financial statements, the standard ultimately adopted by the PCAOB should, at a minimum, require auditors to address a company's internal controls for fighting fraud.

Sincerely,

Guidance Software, Inc. by:

/s/ Victor T. Limongelli

Victor T. Limongelli
General Counsel

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[1] Release, at 20-21.
[2] Representative Bentsen, 148 Cong. Rec. H5462-02, at *H5467.
[3] Congress acted "in response to Enron, Global Crossing and other bankruptcies." Representative Oxley, 148 Cong. Rec. H5462-02, at *H5462. *See also* "The events of the past months have underscored the importance of transparency in corporate governance. While many believed that Enron was an isolated occurrence, the failures of Tyco, Global Crossing, and WorldCom have eroded confidence in the markets, both here and overseas" Representative Jones, 148 Cong. Rec. H5462-02, at *H5469.
[4] According to Senator Sarbanes, "[t]he bill sets significantly higher standards for corporate responsibility governance. . . . There are also extensive criminal penalties contained in this legislation . . . These provisions, among other things, require the CEOs and CFOs to certify their company's financial statements under penalty of potentially severe punishments." Senator Sarbanes, 148 Cong. Rec. S7350-04, at *S7351.
[5] 68 FR 36636, 36643, June 18, 2003.
[6] Another galvanizing factor was the rampant destruction of computer evidence that occurred in the Arthur Andersen/Enron case. *See* the Arthur Andersen indictment, which alleges that "an unparalleled initiative was undertaken to . . . delete computer files" available at:
http://news.findlaw.com/hdocs/docs/enron/usandersen030702ind.pdf
[7] 68 FR 36636, 36638, June 18, 2003.
[8] Release, § 6.
[9] 68 FR 36636, 36640, June 18, 2003 (Emphasis added).
[10] Release, Appendix C, ¶ C1.
[11] COSO Framework, at 25.
[12] Release, § 24.

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[13] Even before the passage of Sarbanes-Oxley, the SEC's official position regarding internal investigations was that effective self-policing and cooperation with law enforcement could reduce or even eliminate a corporation's liability for violation of the federal securities laws. For instance, the SEC's investigation into Seaboard Corporation found that the controller of one of Seaboard's divisions had caused Seaboard's books and records to overstate assets and understate expenses, and had subsequently actively concealed such misstatements. *See In the Matter of Gisela de Leon-Meredith*, Exchange Act Release No. 44970 (October 23, 2001). Although the SEC ordered relief against the controller, it took no enforcement action against Seaboard, due to the company's prompt and thorough response to the incident, as well as its cooperation with the SEC. *See* Exchange Act Release No. 44969 (October 23, 2001). The SEC noted that the public at large benefits when "businesses seek out, self-report and rectify illegal conduct." Id. The SEC, in deciding "whether, and how much, to credit self-policing, self-reporting, remediation and cooperation," (Exchange Act Release No. 44969 (October 23, 2001)) established four broad measures for it to assess:

- Self-policing prior to the discovery of the misconduct . . .
- Self-reporting of misconduct when it is discovered, including conducting a thorough review of the nature, extent, origins and consequences of the misconduct . . .
- Remediation . . . modifying and improving internal controls . . .
- Cooperation with law enforcement authorities, including providing the [SEC] staff with all information relevant to the underlying violations . . .

SEC Release 2001-117 (October 23, 2001). Indeed, in order to cooperate effectively with the SEC and law enforcement, a company must be able to "identify . . . evidence with sufficient precision to facilitate prompt enforcement actions against those who violated the law." Exchange Act Release No. 44969 (October 23, 2001).
[14] COSO Framework, at 53.
[15] COSO Framework, at 18.
[16] Release, § 14.
[17] Release § 126.
[18] Although Section 123 of the Release mentions "antifraud programs and controls," it does so in the context of discussing the interaction of qualitative and quantitative considerations. It would be better addressed in Section 126.

Harsco

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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

Ladies and Gentlemen:

Harsco Corporation appreciates the invitation to comment on the proposed auditing standard. Harsco is a diversified, $2 billion industrial services and engineered products company with operations in over 40 countries.

Harsco Corporation supports the Board's objective to establish a consistent standard for evaluating management's assessment of the internal controls over financial reporting and recognizes the need for such guidance due to the fact that the audit requirements are substantially different from the traditional financial statement audit. We are, however, concerned that the compliance costs associated with the proposed standard, both in terms of external audit fees and internal expenses, will be excessive. Harsco is comprised of a diverse group of businesses in approximately 400 locations, many of which are not individually significant but are separate reporting units. The company historically has a strong internal control culture and framework. The requirements of this standard, specifically the level of detail testing to be performed by the external auditors, will result in significantly higher external audit fees.

The following comments more specifically outline our concerns over the proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*. Our responses are arranged to correspond with the thirty-one questions provided in the Summary Section of PCAOB Release No. 2003-017, however, we have only responded to those questions for which we have a comment.

Question 5: *Should the Board, generally or in this proposed standard, specify the level of competence and training of audit personnel that is necessary to perform specified auditing procedures effectively?*

This proposed standard should not specify the level of competence and training of audit personnel. An evaluation of the competence of audit personnel should be accomplished through separate standards applied to the external auditing profession as a whole. Setting specific guidelines in this standard may result in unnecessary increases in external audit fees.

Question 6: *Is the scope of the audit appropriate in that it requires the auditor to both evaluate management's assessment and obtain, directly, evidence about whether internal control over financial reporting is effective?*

The overall scope of the audit standard appears appropriate; however, we have the following specific concerns relating to definitions provided in the standard. First, the requirement in paragraph 57 that the auditor evaluate the audit committee's *level of involvement and interaction with the independent auditor, including the committee's role in the appointment, retention, and compensation of the independent auditor* is an inherent conflict of interest. The definition should be modified to be more specific about the auditor's responsibility and to reduce the subjective nature of the evaluation. For example, to address whether the committee is adequately involved in the appointment and retention process, the auditor could determine that the audit committee formally approved the fees and conducted interviews with the external audit firm.

Secondly, the definition in paragraph 61 could easily be construed to include every balance in the financial statements. This current definition is too broad in stating that the misstatements should be considered significant if they could be material when aggregated with others. It would be difficult, if not impossible, to exclude any accounts based on this criteria. The standard should be revised to require a materiality assessment similar to the requirements in a traditional financial statement audit.

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

We believe that it is appropriate to include such criteria. However, the standard currently does not emphasize that the documentation criteria listed in paragraph 43 should be considered in the context of the overall control environment and management's understanding of the relevant business processes. For example, company management may be able to gain comfort over a relevant cycle through a combination of documentation forms such as control questionnaires, division policies, desk procedures and job descriptions, because of their general understanding of the business and related risks. The standard should expand on paragraph 44 to clearly state that multiple forms of documentation, even over the same relevant business cycle, may be sufficient. Requiring companies to consolidate all of the relevant items in the criteria into one all encompassing form of documentation is not justified.

Question 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?*

Inadequate documentation should be considered an internal control deficiency but should not automatically rise to the level of significant deficiency or material weakness. In a diverse entity with many divisions and reportable entities, the significance of inadequate documentation must be evaluated in combination with many other factors. Examples include the overall control environment, management's involvement and understanding of the business, the results of internal control and financial statement audit testing, etc.

Harsco

Question 10: *Is it appropriate to require that the walkthrough be performed by the auditor himself or herself, rather than allowing the auditor to use walkthrough procedures performed by management, internal auditors, or others?*

The performance of walkthroughs are a key step in gaining an understanding of the controls in place over a relevant business cycle. However, the fact that the auditors may only place reliance on the walkthroughs they perform themselves is very restrictive. At a minimum, walkthrough documentation performed by an effective internal audit department and reviewed by external auditors should provide a level of additional assurance and be considered part of the overall testing coverage. The benefit of allowing some limited reliance is that in many cases, internal audit has a better understanding of the company's systems and can more efficiently and effectively perform and document walkthroughs. The external auditor should still be expected to review the walkthrough documentation in the same manner that they would review their own staff's work.

Question 11: *Is it appropriate to require the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year or may the auditor use some of the audit evidence obtained in previous years to support his or her current opinion on management's assessment?*

Similar to the approach used in the financial statement audit, the auditor should be expected to obtain assurance over key account balances and disclosures on an annual basis. The difficulty in applying this standard to the evaluation of the effectiveness over internal control is that many entities have very diverse operations with numerous divisions which are not material to the financial statements as a whole. Requiring the auditor to evaluate each year independent of previous efforts would exclude the auditor from gaining some level of assurance from periodic visits to smaller locations. It would also require the auditor to focus only on the most significant locations each year in an attempt to get to the necessary coverage while not reviewing smaller entities where the risk of errors or fraud could be higher.

Initial feedback from the external audit firms seems to indicate that their focus will be on quantitative annual coverage, including management's testing coverage. We are concerned that the internal audit plan and other management testing plans may have to be modified to achieve this quantitative coverage annually at the expense of focusing on locations where, regardless of size, the perceived or qualitative risk is higher. Allowing for some assurance to be gained from prior year work should help alleviate this pressure.

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

As noted in our response to question 10, the standard should allow additional work performed by an effective internal audit function to be relied upon to some degree. The level of this assistance and the evaluation of the internal audit function should closely resemble the guidelines in AU sec. 322 (The Auditor's Consideration of the Internal Audit Function in the Audit of Financial Statements).

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

The guidance provided in paragraph 104 regarding those controls where the auditor should not use the results of testing performed by management should be clarified. Specifically, the description of controls over the period-end financial reporting processes identifies controls to initiate, record and process journal entries in the general ledger; and to record recurring and nonrecurring adjustments to the financial statements. This definition is too broad and should be narrowed to focus on journal entries, report combinations and reclassifications at the Corporate and/or Business Segment level. The current definition may restrict the auditor from relying on internal audit work at remote locations and smaller entities which may not receive external audit attention but where the testing performed by management at these locations could provide some level of assurance regarding the overall control environment of the company.

Further, the definition of *certain information technology general controls* should be clarified to provide specific examples of those types of controls that the standard intends to address.

Question 15: *Is the flexibility in determining the extent of reperformance of the work of others appropriate, or should the auditor be specifically required to reperform a certain level of work?*

The external auditor should be required to evaluate the extent of reperformance on a case-by-case basis based on their assessment of the entity performing the test (i.e., management, internal audit, etc.). The current standards over the external audit profession adequately address this issue.

Question 17: *Will the definitions in the proposed standard of significant deficiency and material weakness provide for increased consistency in the evaluation of deficiencies? How can the definitions be improved?*

The definition of significant deficiency as proposed is not adequate to increase consistency in the evaluation process. The definition of the terms *more than a remote likelihood* and *more than inconsequential in amount* are not sufficient and may result in a wide range of interpretations. The examples provided in Appendix D draw conclusions that items are significant deficiencies without any quantitative consideration. Similar to our response to Question 6, the definition of significant deficiency is vague and will make it difficult for any identified control exception to not be considered a significant deficiency.

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

Yes, the severity of each deficiency needs to be considered in order to form an opinion on the overall assessment of the effectiveness of internal control.

Harsco

Question 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, all items which are determined to be internal control deficiencies should be reported to the audit committee in a manner similar to the traditional financial statement audit management letter. This process will provide key feedback to management in their continuing efforts to strengthen the internal control environment within the organization.

Additional Comments:

Requirement for Written Representations:

The standard defines certain required written representations from management that the auditor must obtain in paragraph 128. Part F requires that management must *state whether previously identified internal control deficiencies have been resolved, and specifically identifying those that have not*. This should be modified to require representation only as it pertains to those deficiencies classified as significant. The internal control environment within any organization is continually evolving and a requirement to represent to all deficiencies, regardless of significance is not practical.

Respectfully Submitted,

Layne Kocher, C.P.A.
Director – Internal Audit
Harsco Corporation

Via Electronic Mail

THE HARTFORD

November 18, 2003

Robert J. Price
Sr. Vice President & Controller

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

Dear Mr. Secretary:

The Hartford Financial Services Group, Inc. (The Hartford) supports the requirement of the Sarbanes-Oxley Act of 2002 to have management report annually on its assessment of internal controls over financial reporting and we appreciate the opportunity to comment on the draft proposed auditing standard: *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (the "Draft Standard").

We have reviewed the draft standard and the 25 page summary provided by the PCAOB in its Release No. 2003-17 dated October 7, 2003 (hereinafter referred to as "the Summary"). While we support the majority of the concepts in the proposed draft, we believe that a number of the requirements made of the public accountants may have unintended consequences and do not lead to better audits or stronger controls.

Most of the well-publicized audit failures can be attributed to one or more of three conditions: failure of the business, senior management overriding the internal controls, or inappropriate application of accounting principles. Yet the draft audit standard seems to require that public accountants (either directly or by reliance on others) apply the same level of scrutiny to routine processes as they do to higher risk estimation processes or management level controls. One example of this is the proposed requirement to have the public accountants perform walkthroughs of <u>every</u> financial process of any significance, no matter how routine. Another example is the requirement that each year the external auditors must test controls over a "large portion" of locations or business units that are individually not material even when strong company-level monitoring controls are in place and operating effectively.

The scope of work required by management under Sarbanes-Oxley Section 404 is vast and we question whether the PCAOB has a true appreciation for the enormity of work that the external auditors would have if they have to follow the scope of work spelled out in the draft auditing standard. To address the requirements of Sarbanes Oxley Section 404, management of The Hartford is in the process of documenting its significant process and sub-processes, including all key risks and controls over financial reporting. The exponential growth in detail documentation that the Company is developing is significant. While we agree that it is important for the auditor to evaluate this documentation, on a test basis, to help foster an appreciation and understating of the Company's internal control, the sheer volume of documentation also poses a potential risk. Requiring certain detailed procedures or tests presents the risk that the auditors will focus on too many detailed risks without being able to see the "forest from the trees". This could create an environment where the auditors and management are at greater risk of missing important financial reporting matters because of limitation of time and resources and shifting audit or testing focus away from the areas of greatest risk.

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We have responded to a number of questions raised in the PCAOB briefing letter on the draft auditing standard and have listed those questions below by number. Some of our greatest concerns regarding this draft standard are in the area of the nature and scope of testing being required. We have included on comments addressing these concerns at the end of our comment letter in the "General Comments" section.

We would be happy to respond to any further questions you or your Staff may have. You may call me at 860-547-8495.

Robert J. Price
Senior Vice President and Controller

Summary of Key Points

Reliance on management, internal auditors or others

The proposed standard limits the external auditors' ability to rely on internal auditors or management. In particular, we do not agree that the external auditor should be prohibited from using management or internal auditors to perform walkthroughs or test IT general controls.

In the Summary, the PCAOB noted that, "the work that management performs in connection with its assessment can have a significant effect on the nature, timing, and extent of the work the independent auditor will need to perform. The proposed auditing standard would allow the auditor to use, to a reasonable degree, the work performed by others, including management. Thus, the more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be. "

However, the restriction on the use of the work of management or internal auditors significantly impairs the ability of auditors to reduce their workload through reliance on others.

Since reliance on the work of management is a new concept, we suggest that the PCAOB consider developing specific criteria to govern the external auditor's ability to rely on work of management. This guidance should be relatively similar to the guidance espoused by Statement of Auditing Standard No. 65, but should define how the concepts of "objectivity" and "competency" apply to management.

Definition of significant deficiency and material weakness

We disagree with the definition of a significant deficiency as provided in the Draft Standard. The definition provided is overly broad and does not allow for the level of judgment required in such an evaluation.

We disagree that a deficiency in the area of non-routine, non-systematic transactions, and antifraud programs and controls should automatically be considered a significant deficiency. The auditor should evaluate deficiencies in these areas, as with other deficiencies, for the likelihood and magnitude of potential financial misstatements. To limit the auditors' judgment in the area through the use of this "bright line" rule for significant deficiencies can result in an insignificant flaw being reported as a significant deficiency that would be misleading to the readers of the financial statements.

The evaluation of internal control deficiencies is an area of significant auditor judgment. Since management and the auditors are only evaluating significant risks and controls under SOX 404, it would be helpful if the PCAOB gave examples of deficiencies that do <u>not</u> meet the threshold of a significant deficiency.

Extent of testing needed

- Auditors should perform walkthroughs for a sub-set of significant processes, not every significant process. Auditors should be able to validate the effectiveness of controls over all financial assertions relating to a sub-set of processes rather than for every process and sub-process that impacts a significant account. To this point, we feel that the PCAOB should clarify whether control assertions must be tested at the account level or the process level since it can mean the difference between testing a sub-set of the key controls or testing virtually all of the key controls (ie auditing 100%).
- Auditors should not have to perform testing themselves at a "large portion" of field office locations if company-level controls over those locations are strong or if the controls are tested by management, internal auditors or others.

Auditors should not have to test every application control every year unless program change controls are weak.

- In some cases, observation and inquiry alone should be sufficient to test the operating effectiveness of controls. Observation of certain application controls (system edits) is one example.

Responses to Questions Posed by the PCAOB

The Company has considered all of the questions raised by the PCAOB. We have only responded to those questions where we have a comment on the draft wording.

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

Yes, we agree that the external auditor should perform some walkthroughs of key processes. The auditors should perform sufficient testing to be able to draw a conclusion and extrapolate the results of that testing to the overall population. Further they should expand their scope, as necessary, based on their risk assessment and test results. We do not believe that the auditor should be required to perform a walkthrough of "all of the company's significant processes". The theory of auditing is based on the concept of testing samples of data, giving effect to differential expectations of risk, not 100% re-performance. We recommend that the PCAOB consider what is meant by "significant" in this context. If the PCAOB intended the auditor to use a different threshold than management uses for determining which processes are significant, then the PCAOB should make that clear.

Since the auditors are auditing management's assessment of controls and are not opining directly on the internal controls, the auditors should examine both processes and controls on a sample basis. As indicated in the Summary, auditors are not expected to test every single control. Further, paragraph 74 of the Draft Standard indicates that in determining which controls to test, the auditor should select those controls that are most important to achieving the control objective and those controls where there is a greater risk that the control is not operating effectively. We believe that the auditor should be able to apply similar judgment in determining which processes to walkthrough.

To perform management's assessment of internal controls over financial reporting under SOX 404, The Hartford has identified all significant accounts and the processes and sub-processes that generate those account balances and related disclosures. For each sub-process, we have identified control objectives related to every relevant assertion. We have then evaluated the specific risks for each control objective and the key controls in place that mitigate each risk. This is an extremely time consuming and detailed project, with numerous processes, in many cases with multiple sub-processes, and with each sub-process there are a multiple of key controls to address the financial reporting assertions. This exponential growth in detail results in volumes of documentation. While we agree it is important for the auditor to gain an understanding of the Company's internal controls, requiring the auditor to personally perform every walkthrough leads to an undue burden on the auditor, while providing virtually no incremental benefit to the overall audit process.

From our own experience in documenting our significant processes, the auditor would be forced to spend an inappropriately large amount of time performing walkthroughs of all our significant processes. The draft standard makes it clear that a walkthrough is far more than merely inquiring about the accuracy of a flowchart; it requires the auditor to confirm their understanding of the process flows by such procedures as observing the processing of a transaction from start to finish. Although walkthroughs are an important part of any audit, we believe that if auditors have to perform walkthroughs of every process and sub-process, this may divert the auditors' attention away from evaluating controls over the higher risk areas of the company.

If the PCAOB ultimately determines that the auditors are required to perform walkthroughs of every significant process, which we strongly oppose, then given the large volume of significant processes, the auditors must be able to rely to some degree on walkthroughs performed by management, internal auditors or others.

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?

The requirement that the auditor perform walkthroughs themselves, in all cases, is not necessary and does not add to the effectiveness of the audit. We noted that the Summary states, "Because of the judgment that a walkthrough requires and the significance of objectives that walkthroughs allow the auditor to achieve, the proposed auditing standard would require the auditor to perform the walkthroughs himself or herself." We disagree with the idea that all walkthroughs, particularly for many of the routine and certain lower risk non-routine processes, require significant judgment to evaluate. Generally, the objectives of walkthroughs can be obtained more effectively and efficiently by leveraging the work of management or internal audit in the compilation of walkthrough documentation.

As stated in the existing audit standard of due professional care, "gathering and objectively evaluating audit evidence requires the auditor to consider the competency and sufficiency of the evidence." For routine processes and lower-risk non-routine processes, the external auditor should be able to rely on management or internal auditors to perform the walkthroughs as long as management or internal auditors keep sufficient documentation of the process flows and related internal controls.

Further, for the reasons provided in our response to question No. 9, we do not believe it is practical for the auditor to perform walkthroughs of every single significant process themselves.

Even more simply, if the auditor can rely on management, internal auditors or others under certain conditions to test the internal controls (as proscribed under the Draft Standard), then they should also be able to rely on them to perform a portion of the walkthroughs. To exclude the auditor from relying on others to develop the walkthrough documentation is inconsistent with other concepts within the draft standards.

While we believe management or internal auditors should be able to perform some of the walkthroughs, we agree that the external auditors should perform walkthroughs themselves of higher risk areas and should independently validate some of the walkthroughs done by management or internal auditors.

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 no management's assessment?

We agree that the auditor should obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts every year, but believe this guidance should be clarified in the case of testing of controls at multiple locations or business units and testing IT application controls.

As discussed in our General Response section, we believe that the auditor should be able to test a sample of locations within a group when all locations in the group have the substantially the same processes and controls and the monitoring level controls are operating effectively. Following this approach, the auditor would be testing controls over all relevant assertions for all significant accounts, but would be able to rotate which locations they test each year.

We also believe that if, through some combination of testing by management, internal and external audit teams, the external auditor is able to conclude that a company's IT general controls over release management and access security are operating effectively; neither management nor the external auditor should be required to test every significant application control in the company every year. Effective general controls over the IT environment should provide adequate assurance that the programming logic behind the application controls has not changed, or, even if the logic has changed, that the change had been appropriately tested and that the changes should function as intended. We would support the concept that application controls should be tested on some periodic basis (we would suggest every five years) despite the presence of strong IT general controls over release management and access security since the IT general controls do not specifically address the application control. As a result, we suggest that the PCAOB adopts guidance that provides benefit for having effective general IT controls, and provides further criteria for evaluating the frequently of re-testing application controls within an effective IT general control environment.

12. To what extent should the auditor be permitted or required to use the work of management and others?
13. Are the three categories of controls and the extent to which the auditor may rely on the work of others appropriately defined?

We suggest that instead of providing specific areas where the external auditor is either limited or prevented from relying on the work of management or others, the PCAOB should provide additional guidance for reliance on the work of management. The current Statement of Auditing Standard No. 65 "*The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*" provides a good framework to develop similar guidance relating to the use of work of management and others.

We agree with the guidance in paragraph no. 103 of the Draft Standard, which an auditor should apply when evaluating whether they will rely on the work of management, internal audit or others. However, we do not agree with many of the concepts in paragraphs no. 104 and 105, where the PCAOB has set to prevent or limit the external auditors' ability to rely on internal audit or management. The Summary states that "the work management performs in connection with its assessment can have a significant effect on the nature, timing and extent of the work the independent auditor will need to perform. The proposed auditing standard would allow the auditor to use, to a reasonable degree, the work performed by others, including management. Thus, the more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be. " Preventing or significantly limiting reliance on management and internal auditors is inconsistent with the intent expressed in the Summary that allows reliance "to a reasonable degree."

Reliance on the work of others does not mean that the external auditor is prohibited from performing additional procedures. In fact, to the contrary, the current standards require the external auditor to re-perform procedures to develop a level of assurance that the work performed by internal auditors is sufficient for the external auditor to place reliance. SAS No. 65 states, "judgments about assessments of inherent and control risks, the materiality of misstatements, the sufficiency of tests performed, the evaluation of significant accounting estimates, and other matters affecting the auditor's report should always be those of the auditor." We agree that these concepts are appropriate and should also be considered when evaluating the reliance on work performed by management and others.

Specifically, we would like to address certain components of this area of the Draft Standard, including: the concepts of "objectivity" and "competence", areas where reliance on management is limited, and areas where reliance on management is limited.

Requirement of "objectivity" and "competence"
Without additional guidance on what is meant by "objectivity" and "competence", we believe the external auditors would be reluctant to rely on the work of management. While there is professional guidance on when external auditors can rely on internal auditors, the draft standard does not make it clear if those same principles would apply to management. Under SAS 65, external auditors can rely on the work of internal auditors when certain conditions are met. For example, internal auditors must have adequate education and experience, work for individuals who hold professional certifications, receive sufficient training, follow professional auditing standards and remain independent within the organization, just to name a few of the criteria. If those same principles apply to management, very few process owners or control owners throughout the company would meet the standard. If a different standard for objectivity and competence should apply to management, that standard should be made clear.

We believe the PCAOB could define "competency" as being a person who is senior in level and experience to the person who performs the control and who has an adequate understanding of how the process works. We believe that the concept of "objectivity" should apply to the manner in which the employee performs the test, but not to the working relationship of the tester to the person who performs the control. Otherwise, it would be difficult to find people within operations who are competent enough to be a tester of controls but who are divorced from the process itself.

With regard to the areas where the draft standards have provided limitations or restrictions on the external auditor reliance on work of management or others, we have the following comments:

Areas where reliance is prohibited
We agree that it is appropriate for the external auditors themselves to review controls that are part of the control environment and controls over the period-end financial reporting process. However, we do not understand why the external auditors should not be able to use the work of internal auditors in evaluating IT general controls. While we agree that application controls depend on the operating effectiveness of IT general controls, the failure of an IT general control does not typically have the same consequence on the financial statements as a failure in either the controls over the control environment or the controls over the period-end financial reporting process.

Perhaps at issue is what is meant by the term "certain" IT general controls. We are unclear which IT general controls the PCAOB is referring to by this term. The Hartford has over 200 application systems in scope under Sox 404. Even if our external auditor only evaluates controls over a sub-set of that population, it is still a significant amount of work.

Areas where reliance is "limited"
The PCAOB should issue more guidance on when the external auditor can rely on the work of management or others to test controls over non-routine and non-systematic transactions and controls over high risk accounts, processes or disclosures. Based on the wording in the draft standard, we doubt that any external auditor would risk relying on management or internal auditors to test these controls for fear of running afoul of the standard.
When management, internal auditors or others are relied upon to test controls over non-routine and non-systematic transactions or controls over high-risk accounts and processes, the auditor would typically perform substantive audit procedures on the account balances. These substantive procedures help the auditor evaluate the effectiveness of management's testing of key controls in these areas. Therefore, we do not believe that reliance on management, internal auditors or others in these areas should be as "limited" as conveyed in the draft standard.

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?

We do not believe that the proposed standard provides for an appropriate recognition of the work of internal auditors. We believe that the draft auditing standard inappropriately restricts the auditor's use of internal auditors far beyond the restrictions already set forth by SAS 65 "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements". Under SAS 65, the auditor can rely on internal auditors provided that internal auditors are found to be objective and competent as defined under the standard. SAS 65 does not prohibit use of internal auditors in any specific area, but says that the auditor should consider the materiality, risk and subjectivity of an account balance in determining when to do the audit testing themselves. We do not believe that SOX 404 intended to redefine SAS 65, which has not been the cause of any of the recent financial reporting problems that have occurred.

16. Is the requirement for the auditor to obtain the principal 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?

We agree that the external auditor should validate the work performed by management, internal auditors or others in order to opine on management's assessment of internal controls. We also believe that it should be the auditor's judgment as to how much re-performance of testing they need to do in order to obtain "principal evidence" that the controls are operating effectively, which is consistent with the current draft standard.

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?

The definition of significant deficiency appears unreasonable and inconsistent with previous standards. The Draft Standard defines a significant deficiency as a control deficiency or combination of deficiencies that results in a more than remote likelihood of a more than inconsequential misstatement. This definition appears to be much too all encompassing and does not allow for much latitude when evaluating specific control deficiencies.

We do not believe that control weaknesses over non-routine and nonsystematic transactions should automatically be considered significant deficiencies. The same principles of assessing the likelihood and potential magnitude of a misstatement should be applied when evaluating controls over non-routine and non-systematic transactions. While the inherent risks of a financial misstatement may often be higher with non-routine or non-systematic transactions, this is not always so. For example, the issuance or repayment of debt is a non-routine process, but inherently has very low risk.

We also do not believe that the ineffectiveness of a company's regulatory compliance function should be considered a strong indicator of a material weakness unless related to compliance over financial reporting.

While we agree that an effective compliance function is important, the ineffectiveness of a company's regulatory compliance function should not be considered a material weakness except with respect to laws and regulations which have a material effect on the reliability of financial reporting, such as Regulation S-X.

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 examples in Appendix D give insight as to when a significant deficiency should be considered a material weakness, but we believe that more guidance should be given as to when a control deficiency reaches the threshold of a significant deficiency. Implicit in the definition provided in the draft standard is the concept that a control deficiency is not a significant deficiency merely because it relates to a relevant assertion of a significant account. There must also be a more than remote likelihood of a more than inconsequential misstatement. Yet the draft standard also says that the significance of a deficiency depends on the potential for a misstatement, not on whether a misstatement has actually occurred. Since SOX 404 only evaluates controls that reduce the risk of potential misstatement to an acceptable level, it is unclear when a control deficiency would not be considered significant under the draft standard.

The proposed statement on auditing standard, *Communication of Internal Control Related Matters Noted in an Audit,* dated March 18, 2003, defines significant deficiency as an "internal control deficiency 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". The proposed standard goes on to state that the auditor should consider a number of factors in evaluating whether a deficiency is significant, including the likelihood the deficiency could result in a misstatement, the magnitude of potential misstatements, the importance of the control, the nature of the account balance and the frequency of exceptions. This definition is consistent with earlier definitions of significant deficiency in audit literature, including the definition of reportable conditions under SAS 60.

The PCOAB has significantly changed the definition of "significant deficiency" in issuing the draft auditing standard. While the line may be "brighter" under the newly proposed definition, it is hard to conceive of a deficiency that falls below the threshold of "more than remote" or "more than inconsequential". If so, that would mean that all virtually all deficiencies are "significant" and we question whether that was the PCAOB's intent.

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

We do not believe the effectiveness of a company's regulatory compliance function is relevant except to the extent the company must comply with laws and regulations which have a material effect on the reliability of financial reporting, such as Regulation S-X. The SOX 404 final rule states that, "our definition (of internal control over financial reporting) does not encompass the elements of the COSO Report definition that relate to the effectiveness and efficiency of a company's operations and a company's compliance with applicable laws and regulations, with the exception of compliance with the applicable laws and regulations directly related to the preparation of the financial statements".

The concept identified in SOX 404, is further repeated in the draft standard paragraph that states "internal control over financial reporting does not ordinarily encompass elements related to the effectiveness and efficiency of operations or compliance with laws and regulations. However, operations and 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." The statement that an ineffective regulatory compliance function is a strong indicator of a material weakness implies that the auditors should be evaluating the regulatory compliance controls, which were previously scoped out of the standard and by SOX 404. For insurance companies, there are a vast array of state-by-state regulations that affect how the company must communicate with policyholders and claimants that have no bearing on the reliability of the financial statements. The effort to evaluate the controls over regulatory compliance would take as much time as evaluating the internal controls over financial reporting. While these controls are definitely important, we do not believe that they are in scope for SOX 404.

General Comments

The company has comments on other portions of the draft standard that do not relate to the specific questions asked by the PCAOB.

Control Testing - Scope

The draft auditing standard requires the auditor obtain evidence about the operating effectiveness of controls for all relevant assertions for all significant accounts and disclosures. However, the draft standard is not clear whether the auditor needs to evaluate the controls at a process level or at a significant account level. To illustrate the confusion, we will use premium processing for our property and casualty operations as an example.

We have 19 property and casualty business units that generate written premium. Four of the 19 account for 68% of the written premium (based on 2002 calendar year data). The other 15 business units range from 1% to 8% of the total, where each of the 15 is at least 2 to 3 times our materiality threshold of $35 million. Accordingly, all 18 business units are "individually financially significant" to use a term in the draft auditing standard. Each of the 15 smaller businesses market different products and have unique processes.

If the auditor interprets your draft guidelines to mean that a walkthrough and test of controls is required at the process level, then all of the premium financial statement assertions need to be tested for all sub-processes within each of the 19 business units because every sub-process is "significant". If, however, control testing is required at the significant account level, the auditor could test relevant assertions over written premium for the four largest business units plus a portion of the remaining 15 business units. We believe the latter approach is more reasonable. As with a financial statement audit, we do not believe the auditor should have to test 100% of an account balance to gain audit-level assurance.

We believe it is more appropriate that the auditor test control assertions at the account level than the process level. If the auditor, like management, is required to test controls over relevant assertions for every significant process, the auditor would be required to test nearly all of the controls. Management's scope of testing and the auditor's scope of testing would only differ to the extent that the auditor determines that some of the specific risks related to a particular financial statement assertion or control objective are not that important. We do not believe that an audit of management's assertion should require the auditor to test nearly every control, and we think that the scope difference between management and the auditor needs to be more clearly defined within the standards.

Nature of Testing

We also believe that in some cases observation and inquiry alone can be a sufficient test of operating effectiveness of controls. Paragraph 89 says that because observation is pertinent only at a point in time, the auditor should supplement the observation with inspection of documentation about the operation of such controls at other times. However, we believe that there are some instances where observation should be considered sufficient testing of operating effectiveness, particularly for application controls.

An example is a test of a transaction edit that prevents an employee from processing a payment in excess of a certain dollar amount. In this case, we believe that it would be sufficient for the auditor to observe the employee trying to process a payment in excess of the threshold, provided that the auditor also tested program change controls over the application.

Scope of Testing – Multiple Locations

We are concerned that the discussion in Appendix B on tests to be performed when a company has multiple locations or business units is unclear on whether the auditor can rely on testing at various locations performed by management, internal auditors or others. This is an important clarification since frequently field office locations process a significant portion of a company's routine transactions which is, under the current draft standards, the one area where the external auditor is generally permitted to use management, internal auditors or others to do testing.

If it is true that the external auditor has to perform testing for a "large portion" of field locations, we believe the external auditor should be able to rely on testing done by management or others to fulfill this responsibility. Under SAS 65, "if the internal auditors' plan includes relevant audit work at various locations, the auditor may coordinate work with the internal auditors and reduce the number of the entity's locations at which the auditor would otherwise need to perform auditing procedures".

The Hartford's property and casualty operations have 15 regional offices throughout the country that generate written premium for our small commercial, middle market and marine businesses. Each of the 15 regional offices accounts for at least 2% of the total written premium for those businesses and no one regional office accounts for more than 16% of the total. However, every regional office uses the same systems, has the same processes and controls and is subject to the same monitoring level or "company level" controls as that term is used in Appendix B.

Paragraph B11 of Appendix B states that testing company-level controls is not a substitute for the auditor's testing of controls over a "large portion" of the company's operations or financial position. This guidance fails to recognize that a process that is performed in different locations can be as tightly controlled as when that same process is performed at one location. Appendix B does not allow the external auditor to select a relatively small number of locations or business units even if the "company level" supervisory controls are as strong as they would be if all of the operations were centralized in one location. We believe the PCAOB should re-consider this guidance.

Paragraph B4 of the draft standard makes the statement that "generally, a relatively small number of locations or business units will encompass a large portion of a company's operations and financial position...." This is not always the case. Companies in the insurance industry, for example, typically have a significant number of field locations that underwrite and process claims. Furthermore, we believe that there are many companies in other industries which have either many locations or many business units that account for a significant share of their business.

Furthermore, paragraph B11 of Appendix B provides guidance which conflicts with the language in paragraph B2. Paragraph B2 says that when there are a group of locations that aggregate to a material amount, the auditor should either test company-level controls or perform tests of controls at some of the locations or business units. We agree with the concept in paragraph B2 which implies that the auditor could test controls at a relatively small number of locations as long as they found company-level controls to be working effectively. Paragraph B11, however, seems to prevent the auditor from relying on company-level controls to reduce the extent of their testing. That doesn't make sense to us.

We believe that the auditors can test controls for all relevant assertions for all significant accounts without having to visit a large portion of field offices as long as the field offices have substantially the same processes and controls and are subject to the same monitoring level or company level controls.

Integration and Coordination of Financial Statement Audit and Audit of Internal Controls

The Draft Standard does not specifically address the efficiencies that can be gained through coordinating the efforts of the financial statement audit and those of the audit of internal controls over financial reporting. Without clearly addressing how these two audits are integrally linked, there is a significant risk of excessive cost and wasted effort, with little if any incremental benefit to the investing public and financial statement users. In many instances, an auditor would be able to more efficiently test and validate balances on the income statement or balance sheet without analyzing all of the processes, sub-processes and related internal controls that brought the Company to reporting that balance. In cases where an auditor can more effectively validate a financial statement balance, a reasonable person could also infer that the internal controls had functioned appropriately to support that balance without having to test all of the internal controls. We suggest that the PCAOB specifically address the integration and coordination of the audits of the financial statements and internal control in the Draft Standard. Providing additional guidance in this area will help mitigate the costs of this effort, which is good for the investing public, while providing a consistent level of assurance on a Company's financial reporting processes.

Utilization of Service Auditors' Reports

In section B36 of the Draft Standard, the PCAOB appears to require what is potentially a significant amount of audit work to be performed by management and the external auditors of a Company utilizing service providers, who have SAS 70 reports for periods less than the entire fiscal year covered by management's assertion and the related audit opinion. We believe that a service provider SAS 70 report that; covers an entire year, and either ends on the day before the current fiscal year or some partial period of the current fiscal year, management of the user company should be able to rely on the results of the previous SAS 70 report, as long as management supplements this understanding with inquiries of the service provider company management. We believe that the inquiries of service provider company management should be focused on confirming that a SAS 70 is in process for the current period and asking management to provide negative assurance to the effect that they are not aware of any significant changes in the control environment or effectiveness of the Company's overall internal control that would warrant a significant change to the prior SAS 70 report, including the controls identified and the auditors opinion. Requiring additional independent testing and evaluation by user organizations for SAS 70 reports that do not cover the entire current fiscal year does not appropriately consider the timing delay in issuing SAS 70 reports and results in duplication and wasted audit efforts. These requirements are inconsistent with the intent of SAS 70 reports, which were meant to eliminate the need for user organizations to have to perform their own independent evaluation of the service providers internal control.

We believe that the service providers and audit profession will begin to address the PCAOB's concept of more "fresh" SAS 70 reports by changing the SAS 70 reporting and testing period and/or providing multiple reports per year (either quarterly or semi-annually), or even developing guidance for external auditors to provide for "negative assurance" for interim periods not covered by issued SAS 70 reports. Since these developments have not yet taken place, we would, at a minimum suggest that the PCAOB provide ~~some~~ transitional guidance for the use and reliance on SAS 70 reports. We strongly urge the PCAOB to eliminate requirements resulting in potentially unnecessary work for user organizations (or by their external auditors) related to delays in timing of audit report issuance, particularly where such work does NOT provide any substantial increase in assurance on the effectiveness of internal controls.

November 20, 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 – Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

Dear Board Members:

As Executive Vice President and Chief Financial Officer of the Health Insurance Plan of Greater New York ("HIP"), I am pleased to be able to respond to the request for comments from the Public Company Accounting Oversight Board regarding *Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statement (PCAOB Rulemaking Docket Matter No. 008).*

HIP is a managed care company with revenues in excess of $3 billion. Even though HIP is a not a public company, HIP began the process in February 2003 of building the infrastructure necessary to comply with the provisions of Sections 302 and 404 of the Sarbanes Oxley Act of 2002. HIP chose COSO as its framework for management's assessment of internal controls over financial reporting. As of November 2003, it is projected that the cost to complete the company's initial assessment, document all policies and procedures and perform the initial test work of internal controls will approximate $5 million in consulting hours alone (approximately 30,000 man hours of consulting time). Staffing costs to ensure ongoing compliance are estimated at $2.0 - 3.0 million annually. The company also estimates that annual audit costs may triple from current levels by fiscal 2005 due to the required internal control attestation. As with most managed care companies, HIP faces significant pressures from employer groups to hold premium increases to a minimum, in an environment of rapidly rising medical costs. These additional audit and operational costs, if not recovered in additional savings from internal control improvements, will regrettably have to be passed along to HIP's subscribers, many of whom are small and medium size businesses.

The Sarbanes Oxley legislation specifically states that a public accounting firm that prepares and issues the audit report should attest to, and report on, the assessment of internal controls made by the issuer of the financial statements. The proposed auditing standard requires the external auditor not only to report on and attest to management's assessment, but also to perform a detailed audit of internal controls. If management has properly assessed the effectiveness of the company's internal controls, why is it necessary for the external auditor to duplicate this effort? Current auditing standards allow for an auditor to issue an attestation report on management's assertion over internal controls as opposed to auditing internal controls. Consideration must be given to the additional audit costs incurred and the serious disruptions to the company's operations caused by the duplicate testing and evaluation of internal controls required by the proposed standard.

If the auditor must evaluate and audit the effectiveness of internal controls in addition to attesting to the assessment made by management, why shouldn't they be able to follow current auditing standards related to the use of testing performed by the company's internal audit department? Under current auditing standards if a company has an effective, competent internal audit function that has performed relevant tests, an auditor may rely on such work. Relief should be given in the final standard to allow the auditor to place greater reliance, if appropriate, on management or internal audit's testing of internal controls.

The proposed standard also indicates that each year's audit of internal control must stand alone. If there have been no changes to a particular set of internal control activities, why shouldn't the external auditor be allowed to rotate the activities tested from year to year? The external auditor should be allowed to use some of the audit evidence obtained in previous years to support the current opinion on management's assessment.

We are also concerned that the Board has changed the definition of material weakness in internal controls from what currently exists in auditing standards. Current auditing standards define material weakness as 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 misstatement caused by error or fraud in amounts that would be material in relation to the financial statements….. may occur and not be detected within a timely period…". The proposed standard defines material weakness as "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." We believe that the gap that exists between "low level of risk" of material misstatement and "more than remote likelihood" of material misstatement is significant. Based on the proposed standards, the auditor's attestation of management's assessment of internal control and the effectiveness of those controls is tantamount to a guarantee or warranty that the company's internal controls over financial reporting are effective and result in financial statements that are free of material misstatement. This is an invitation to the plaintiff's bar to bring yet more litigation in our already highly litigious society. The increased risk to auditing firms that will result from such a warranty can only result in greatly increased costs upon those firms and in due course upon public companies.

The requirement in the proposed standard that the external auditor evaluate the effectiveness of the audit committee's oversight is impracticable and untenable. A significant conflict of interest exists in having the external auditor assess the effectiveness of the audit committee, since the audit committee is responsible for hiring, compensating, and supervising the external auditor. The responsibility for hiring and managing the relationship with the external auditor has been placed with the audit committee, as opposed to management, in part to prevent a conflict of interest between management and the external auditor. Requiring the external auditor to evaluate the effectiveness of the audit committee merely re-establishes this conflict of interest at the audit committee level. The suggestion in the proposed standard that the external auditor can provide an honest evaluation of the effectiveness of the committee that determines its tenure to a full Board of Directors is fundamentally flawed. We believe that this process will not result in meaningful evaluations of the effectiveness of audit committees and, therefore, does not serve the public interest. It places unacceptable political burden on the external auditor and does not enhance, but rather complicates, good corporate governance. This aspect of the proposed standard should be dropped entirely.

HIP asks the Board to establish a set of standards that are reasonable, without creating unnecessary costs that are essentially impairing the productivity of public companies. It should be noted that none of the accounting scandals that gave rise to Sarbanes Oxley resulted from breakdowns of systematic operational and accounting controls. Instead, they resulted largely from improper, non-systematic transactions driven by a lack of integrity on the part of management and the Boards of those companies. The proposed standard requires significant focus, and therefore significant cost, be devoted to evaluating internal controls operating within systematic processes. While significant focus should appropriately be directed at material non-systematic transactions, the requirement to expend significant resources evaluating systematic transactions does not appear to be cost-justified. There is no amount of money that can be spent, or control testing that can take place, to prevent unscrupulous, complicit individuals from committing a fraud if said individuals are determined to do so. We strongly urge the Board to consider ways to reduce the burden of the proposed standard, while still achieving the objectives of enhanced financial reporting and protection of the public interest.

Sincerely,

Michael D. Fullwood
Executive Vice President
Chief Financial Officer
Secretary and General Counsel
Health Insurance Plan of Greater New York

From: ksholder@fuse.net
Sent: Monday, November 03, 2003 4:42 PM
To: Comments
Subject: PCAOB Rulemaking Docket Matter No. 008

Public Company Accounting Oversight Board:

RE: PCAOB Rulemaking Docket Matter No. 008

I have read “Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements” (the “Standard”). I agree with the spirit of the document and the purpose of protecting the investing public. In general, I thought that the Standard was well thought out and well written. I do, however, have two comments relating to the standard as follows.

Page 6 of 12 – second paragraph – requires the external auditor to perform the walkthroughs himself or herself. This will cost corporate America and our economy as significant amount of money. Prima facie this precludes reliance on internal auditors to perform the walkthroughs when they are acting on behalf of the external auditor. Many, if not most, companies use their internal audit staff to supplement the external audit staff and reduce audit fees. For many companies that have multiple locations, the internal audit staff will be assigned certain locations by the external auditor. The internal auditor performs the work at these location under the direction of the external auditor and the company achieves financial savings on its annual audit fees. In some instances, these savings are significant.

If the external auditor is required to visit each location under audit and perform the walkthrough procedures himself or herself and (s)he cannot rely on the work of the internal auditor when the internal auditor is working under the external auditor’s direction, this will impose an additional cost of compliance with Sarbanes-Oxley Act section 404 that could be significant. I recommend that the language of this paragraph be changed to allow the external auditor to rely on the work of internal auditors in performing walkthroughs when they are working under the direction of the external auditor. This will provide the appropriate level of security for the investing public and allow companies to achieve significant savings on their annual audit fees.

Page 8 of 12 – last full paragraph – uses the term “significant deficiencies” rather than “reportable conditions.” As the term “reportable condition” is already defined and used in the accounting literature, I recommend that “significant deficiencies” be changed to “reportable conditions.”

I appreciate your efforts in providing assurances to the investing public.

Sincerely,

Kevin S. Holder
Certified Public Accountant

November 21, 2003

RE: PCAOB Rulemaking Docket Matter No. 008

Office of the Secretary, PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

Dear Sir or Madam:

We have reviewed the guidance issued by the Public Company Accounting Oversight Board, "Proposed Auditing Standards – An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements." The Home Depot would like to comment on a few select areas.

Question 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?

Comment: The auditor should be prohibited from performing an audit of internal control over financial reporting without also performing an audit of the financial statements. Auditors obtain significant knowledge of a company through financial statement audits and such knowledge should be leveraged to assist auditors in their conclusions regarding effectiveness of internal controls. We believe it would be difficult to adequately understand a company's internal controls over financial reporting without understanding the financial statements and the relationship between the financial statements and the controls that affect them.

The proposed standard does not provide guidance about the interaction of the audit of internal controls and the financial statement audit. There appears to be a narrowing gap between the internal control related objectives of these two audits and we recommend the Board provide more specific guidance pertaining to the interaction between these two audits.

Question 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?

Comment: An alternative requiring the auditor to perform work comparable to a financial statement audit to support an audit of internal controls would not be appropriate. The audit of internal controls should be included in the audit engagement as specified in the Sarbanes-Oxley Act ("the Act"). The additional cost of the work performed to obtain the audit of internal control over financial reporting would not provide a substantial benefit to the shareholders.

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

Comment: It is appropriate for the Board to provide criteria that the auditors should use to evaluate the adequacy of management's documentation. The extent and type of documentation required should not be left solely to the discretion of the auditors. Providing criteria will enhance the consistency of documentation amongst all companies as well as enhancing the consistency of the auditors' evaluation of these companies.

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

Comment: Based on the objectives noted in the proposed standard, we agree that walkthroughs should be required. We believe that walkthroughs validate the company's documentation of the process.

We strongly recommend however, that the Board consider adjusting the proposed standard to permit substituting classes of transactions for individual transactions (e.g. batch transactions). The proposed standard speaks to individual transactions only.

Question 10 - Is it appropriate to require that the walkthrough be performed by the auditor himself or herself, rather than allowing the auditor to use walkthrough procedures performed by management, internal auditors, or others?

Comment: We agree with the Board in its requirement that auditors perform walkthroughs. However, the proposed standard could provide additional guidance for auditors related to (1) relying on walkthroughs performed by the company, (2) relying on prior year walkthroughs, and (3) the extent of walkthroughs required to be performed.

The Home Depot believes the auditor should be allowed to rely on the walkthroughs performed by the company, including management and/or internal audit. We propose that the auditor re-perform or review a sample of the walkthroughs documented by the company. This is consistent with the Board's proposed standard regarding the Use of the Work of Management and Others. We also suggest that the Board consider concurrent walkthroughs that are performed by the auditors and the company.

Auditors should be required to perform independent walkthroughs for significant processes and for any significant new processes after the first year. For all other processes, the Board should consider allowing the auditors to rely on prior year walkthroughs, as long as they confirm that no significant changes to the process have occurred.

Question 11 - Is it appropriate to require the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year, or may the auditor use some of the audit evidence obtained in previous years to support his or her current opinion on management's assessment?

Comment: The auditor should be allowed to use evidence obtained in previous years. We understand there are instances when prior year evidence is not sufficient and those should be clearly defined in the proposed standard. Such instances include: (1) instances of significant changes to previous year processes and/or controls (2) new processes and/or new controls implemented during the year or (3) any time there is a change in senior financial management. We feel that requiring them to perform the same tests year over year on processes that do not change is not cost beneficial to the company nor does it provide an increased level of assurance to management or our shareholders.

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

Comment: We believe that the extent of the work to be relied upon should be based on the competence and independence of the individuals of the company performing the work and on the significance of the process. Allowing additional reliance on the work of others will ensure compliance with the Act is cost effective without jeopardizing the auditor's evaluation. Further, the auditor should then selectively use the results of re-performance in addition to the auditor's own testing to formulate the conclusion on the effectiveness of internal controls.

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

Comment: The proposed standard clearly defines three categories of control, including examples, and the extent to which the auditor may rely upon the work of others for each of these categories. Both general IT controls and application IT controls are a significant part of the internal controls of the company. The Board should add specific language to the standard to address when the auditor may rely upon the work of management and others pertaining to IT control testing. We believe there are instances in which the auditor could rely on the IT control testing performed by management and others.

<u>Question 14 - Does the proposed standard give appropriate recognition to the work of internal auditors? If not, does the proposed standard place too much emphasis and preference on the work of internal auditors or not enough?</u>

Comment: We do not believe there is appropriate recognition of the work of Internal Audit. In today's environment and due to recent rulemaking, Internal Audit departments are more independent than ever. In addition, as part of the company, Internal Audit departments typically have visibility to many areas of the company, the opportunity to interact with management more frequently, and a significant understanding of company processes and controls across all functions. It is our belief that due to Internal Audit's in-depth knowledge of the business combined with their independence, the work they perform should be considered reliable and the auditors should be encouraged to rely on their work.

<u>Question 15 - Is the flexibility in determining the extent of re-performance of the work of others appropriate, or should the auditor be specifically required to re-perform a certain level of work (for example, re-perform tests of all significant accounts or re-perform every test performed by others that the auditor intends to use)?</u>

Comment: The standard should allow the auditors to exercise judgment and thereby provide guidance rather than specific rules. The flexibility currently specified in the proposed standard in determining the extent of re-performance of the work of others is appropriate. The amount of reperformance will vary from company to company and should be determined based on the auditor's risk assessment of the company and its management.

<u>Question 17 - Will the definitions in the proposed standard of significant deficiency and material weakness provide for increased consistency in the evaluation of deficiencies? How can the definitions be improved?</u>

Comment: We find that the definitions in the proposed standard of significant deficiency and material weakness do not provide for increased consistency in the evaluation of deficiencies. We strongly suggest that the Board expand the discussion around what constitutes a remote likelihood and a material misstatement. Moreover, we suggest that the Board provide specific examples as to how to measure potential misstatement. Such a measurement will prompt additional discussions between management and the auditors in determining if such a misstatement is "more than slight" in addition to determining if its potential magnitude is "more than inconsequential." These definitions are vague in nature and are largely dependent on professional judgment and skepticism. Without further clarification, such judgement will lead to widespread interpretation and inconsistent application.

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

Comment: We believe that it is necessary for the auditor to evaluate the severity of all identified internal control deficiencies when determining their overall conclusion on the effectiveness of internal controls. We strongly believe that each deficiency should not be measured to carry equal weight in the determination as to whether a material weakness exists. Rather, the severity of each should be judged individually and then in conjunction with other deficiencies. We suggest that the Board provide examples further defining when a significant deficiency results in a material weakness.

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

Comment: We suggest that in areas that are highly judgmental and subjective in nature, such as the use of estimates, the board allow auditors the ability to exercise judgement in determining whether a misstatement resulted from an audit. We also believe the standard needs greater definition of what constitutes an ineffective internal audit function.

Finally, valid reasons may exist for not correcting significant deficiencies communicated to management in a timely manner. As such, the auditor's focus should not be on if the items have been corrected, but rather how the company has addressed the issues. There may be valid reasons why certain deficiencies may require significant amounts of time to correct.

Question 22 – Is it appropriate to require the auditors to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting?

Comment: We believe it is not appropriate to require the auditors to evaluate the effectiveness of the audit committee regarding financial reporting. Such oversight removes independence between the audit committee, which hires, fires, and compensates the auditor. Generally, if the audit firm were to disagree with the audit committee's effectiveness, the auditor would take corrective action.

Question 24 – If the auditor concludes that ineffective audit committee oversight is a material weakness, rather than require the auditor to issue an adverse opinion with regard to the effectiveness of the internal control over financial reporting, should the standard require the auditor to withdraw from the engagement?

Comment: We do not believe it would be appropriate to require the auditor to withdraw from the engagement. The auditor should complete the audit and issue the audit opinion. Staying engaged would provide greater protection to shareholders. Furthermore, an ineffective audit committee does not prevent the completion of the audit and evaluation on the internal control over financial reporting.

Question 30 – Are the auditor's differing levels of responsibility as they relate to management's quarterly certifications versus the annual (fourth quarter) certification, appropriate?

Comment: The differing levels of responsibility between annual and quarterly reporting is appropriate as the auditor does not have a responsibility to report on their audit of internal controls on a quarterly basis. Parallel to the auditor's current quarterly requirements, it is appropriate for the auditor to perform limited procedures each quarter to determine if there are any material modifications to the disclosures of internal controls. Further, if during the course of a quarterly review, the auditor becomes aware of misconduct, the auditor should bring the matter to the attention of management and the audit committee and if necessary consider withdrawing from the engagement.

<u>Question 31 – Is the scope of the auditor's responsibility for quarterly disclosures about the internal control over financial reporting appropriate?</u>

Comment: We believe that the scope is appropriate and that no measurable benefit would arise from increased responsibility on a quarterly basis.

Very truly yours,

/s/ Carol Tomé

Carol Tomé, Executive Vice President and Chief Financial Officer
The Home Depot

November 21, 2003

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

RE: Rulemaking Docket Matter No. 008 (PCAOB Release No. 2003-017)
Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

Dear Board Members:

The Audit and Assurance Services Committee of the Illinois CPA Society is a voluntary group of CPAs from public practice, industry, education, and government. We take an active role in the standards setting process and have spent considerable time over the past few years responding to audit-related exposure drafts issued by the AICPA, the GAO, the SEC, and other professional organizations.

We welcome the opportunity to comment on the proposed auditing standards being considered by the PCAOB. Our comments represent the collective views of the Committee members and not the individual views of the members or the organizations with which they are affiliated. Our comments have been structured to respond to each of the questions asked as part of the exposure process. The organization and operating procedures of our Committee are outlined in Appendix A to this letter.

QUESTIONS POSED BY THE PCAOB (in bold) and COMMITTEE RESPONSES

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?**

   Yes.

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 single firm or auditor should be required to perform audits of internal controls and financial statements as of a balance sheet date, there should not be a prohibition on additional internal control audits performed at points other than the audited balance sheet date. The PCAOB may want to give companies the option of having additional audits of internal control over financial reporting performed at other points during the year. For companies requiring additional SEC oversight, interim audits of internal controls could become a valuable tool in preventing or detecting financial reporting problems. The financial statement auditors (or other audit firms) should not be prohibited from performing additional audits of internal controls.

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?**

   As noted in #2, we believe flexibility is critical to permit audits of internal controls at points other than the balance sheet date. In these cases, certain testing would be required to evaluate the adequacy of control systems and procedures. An internal control audit could determine that financial information was properly controlled and processed without determining that account balances were fairly presented for financial reporting purposes.

   In addition, the use of the term "complete" in the above question should be clarified. We assumed that the PCAOB did not mean that the auditor must complete the audit and issue a report. Auditors must always have the option of disclaiming an opinion or withdrawing from an engagement.

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?**

   We would agree that for small and mid-sized issuers, auditors should rely on their judgment in determining the nature, timing, and extent of audit procedures required to test internal controls. We believe it would be helpful if the PCAOB provided guidance about the minimum appropriate level of internal control related audit procedures for the smallest of issuers. Similarly, it would be helpful to specify the minimum acceptable level of controls documentation.

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.**

   While presenting guidance on any specialized training needed to ensure auditor competence might be beneficial, a general requirement that competent well-trained auditors perform all audit procedures would not seem necessary. Matters pertaining to fraud, material errors, irregularities, material weaknesses, disagreements with management, and scope limitations should be the responsibility of the most experienced auditors, generally, managers and partners.

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.

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

   Yes. The criteria are appropriate in a broad sense, but there needs to be some corresponding documentation requirements for management to follow. Absent specific management documentation criteria, we believe there will be unacceptable disparity in the extent and quality of controls documentation since it will be based on each auditor's experience and preference.

In addition, paragraph 43 states that the auditor "should evaluate whether such documentation includes the following...". Was this intended to be an all-inclusive listing? Would the phrase "should include the following..." be more appropriate? In addition, we suggest the PCAOB consider how certain terms are being used. Some of the subjective wording such as "significant", "enough", and "material" could be viewed as either helpful if it allows an auditor to use judgment or vague if it leaves items open to interpretation.

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?**

   Due to vast differences in the size of companies and the lack of guidance for management to follow in documenting and evaluating internal controls, instances of inadequate documentation should be considered internal control deficiencies. These deficiencies should be subjected to further evaluation to determine their significance and whether they should be classified as a material weakness or significant deficiency. Auditors should be allowed to use judgment in determining the significance of any weakness or deficiency noted in an audit.

   In addition, the language included in the last sentence of paragraph 46 seems inappropriate and should be reviewed. Allowing management to demonstrate its monitoring of controls in the absence of documentation appears to contradict the intent and spirit of the proposed audit standard. It was unclear what PCAOB intended by this sentence. We recommend that this sentence be eliminated. Otherwise, additional guidance will be needed for auditors to follow when evaluating controls in the absence of documentation.

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

   Yes.

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?**

    No. While some walkthroughs should be performed by the auditors themselves, all auditors should also have the flexibility of using work performed by others. Before relying on any of this work, the financial auditors must satisfy themselves that the internal auditors (or others) were competent and independent. It is a rebuttable presumption that walkthroughs performed by management would not be considered independent and should not be relied upon.

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?**

    In the present day, auditing is often considered to be a continuous process. Where appropriate, auditors should be able to utilize evidence obtained during prior audits, but not rely solely on this evidence to draw conclusions. Audit workpapers should indicate how the auditors reassessed the quality and reliability of this evidence. We might draw too specific a distinction if auditors can use evidence on internal controls that is 11 months old, but not evidence that is 13 months old.

In addition, the PCAOB may want to establish some guidance on the rotation of audit procedures. While auditors must review all major systems every year, how much of the detail testing can be rotated on a multi-year audit engagement? Auditing all controls every year could become cost prohibitive in a large company. More importantly, where there has been no change in personnel, systems, or procedures, testing all controls annually may not be an efficient use of limited audit resources. Audit costs could be reduced by effectively using a rotating approach to controls testing. This rotation often leads to a more thorough examination of the areas selected for testing.

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

The auditor should be required to review reports issued by internal auditors, regulators, and other third parties to identify any internal control deficiencies that came to their attention. However, it should be left up to the auditor's discretion as to whether it would be efficient to test and rely upon this work.

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

No. Auditor judgment should be the prevailing factor in determining the extent to rely on work performed by others. We do not believe auditors should be limited in their use of work performed by internal auditors, regulators or other third parties. As part of every audit, the auditor should be solely responsible for determining whether reviewing and testing such work would be effective and efficient. However, because of management independence issues, auditors should not rely on work performed by management without adequate review and testing.

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?

Yes. The proposed standard gives appropriate recognition to the work of internal auditors. However, the standard does not provide sufficient guidance for determining whether to rely on internal audit work. The ability to rely on internal control reviews performed by internal auditors could become one of the major factors in controlling the costs associated with internal control audits. In many companies, the internal auditors are the entity's experts on internal controls. The auditor should use this work to the extent appropriate and based on his or her judgment.

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)?

Yes, the flexibility is appropriate and necessary. The auditor should determine the extent of reperformance when they choose to rely upon work performed by others. We believe the standard should make it clear that some level of reperformance is always necessary.

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?**

    Yes, the auditor should obtain the principal evidence. It should be clear however, that this evidence may include the testing and reliance on the work of internal auditors, regulators and other third parties.

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?**

    Yes, we agree that the definitions provide needed clarity. One recommended improvement would be to define the term "inconsequential" (as used in Paragraph 3 of Example D-1). It was unclear whether the intent was to differentiate between "immaterial" and "inconsequential" weaknesses.

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?**

    Yes. As noted above, the term "inconsequential" should be defined.

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

    Yes. All deficiencies noted during an audit of internal controls must be accumulated and evaluated to determine whether a material weakness or significant deficiency exists.

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?**

    No. The handling of clearly inconsequential deficiencies should be modified to allow for auditor judgment. During any testing of transactions, many minor deficiencies can be noted. Auditors must accumulate these deficiencies and perform an analysis to determine whether the inconsistencies noted were isolated occurrences or indicators of internal control weaknesses.

    The value of a management letter may be diminished if the document is required to contain a large number of inconsequential control deficiencies. However, some audit clients may request that all deficiencies be reported to management so management can perform its own assessment of the weaknesses noted. Auditors should be given the option of presenting inconsequential deficiencies to management orally.

    In addition, the PCAOB should clarify whether "management" as included in the above question includes the Board of Directors. The guidance should clarify whether the reporting of inconsequential matters must include the Board.

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

    Yes.

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?

Our Committee was equally divided on this question. Half of the members agreed that the auditors should review the effectiveness of the Audit Committee oversight. This work would become part of the internal control evaluation. The effectiveness of Audit Committee oversight would be a major factor in determining the nature, timing and extent of testing.

Other Committee members felt strongly that the auditor would not be in a position to evaluate all aspects of Audit Committee effectiveness, including certain matters of a legal nature. Only the PCAOB would be able to review the effectiveness of public company Audit Committees.

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

No. Even those Committee members that support the PCAOB position in question 22 recognize that this would be a difficult task. Requiring that auditors evaluate Audit Committee effectiveness may sound like a good idea, but may not work in practice. Regardless of the standards in place, audit firms may be hesitant to criticize an Audit Committee. In addition, it may be difficult for financial auditors to determine whether the Audit Committee members met the legal and regulatory requirements for audit committee service in a publicly traded company.

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. Withdrawing from engagements where there is an ineffective Audit Committee would only pass the problem along to another CPA firm. This action would do little to address any underlying problems. In most cases, issuing an adverse opinion to stockholders and investors should be more beneficial. However, auditors must be required to evaluate each case and determine whether to withdraw from the engagement. In situations where the Audit Committee does not possess the independence or the competence to perform effectively, the auditor may decide the risks are higher than acceptable and sever the audit relationship.

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?

Yes, the reporting requirements should be consistent. The auditor should not be permitted to issue a report that is more favorable than management's report.

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

No.

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?

Yes.

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

Yes. It would be helpful to have specific guidance to clarify permissible services. For example, guidance would be helpful to distinguish how the auditor can make substantive recommendations to management for improving the design of internal controls without these recommendations being classified as "design" work thereby impairing independence.

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

Yes. Based on the assumption that the PCAOB is not comfortable with the auditor becoming a participant in the process of designing internal controls over which he/she will issue an audit report, the standard should prohibit any role in the design, documentation, or implementation of internal controls. Any internal control related services performed by financial statement auditors could have independence implications.

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. The PCAOB has made a reasonable distinction between the auditor's responsibilities for information in management's quarterly versus management's annual certifications.

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

Yes.

The members of the Audit and Assurance Services Committee of the Illinois CPA Society thank you for the opportunity to respond to this proposal.

Sincerely,

William P. Graf, Chair
Audit & Assurance Services Committee

Scott P. Bailey, Chair
Comment Letter Subcommittee

APPENDIX A

ILLINOIS CPA SOCIETY
AUDIT AND ASSSURANCE SERVICES COMMITTEE
ORGANIZATION AND OPERATING PROCEDURES
2003 - 2004

The Audit and Assurance Services Committee of the Illinois CPA Society (Committee) is composed of the following technically qualified, experienced members appointed from industry, education and public accounting. These members have Committee service ranging from newly appointed to more than 20 years. The Committee is an appointed senior technical committee of the Society and has been delegated the authority to issue written positions representing the Society on matters regarding the setting of auditing standards. The Committee's comments reflect solely the views of the Committee, and do not purport to represent the views of their business affiliations.

The Committee usually operates by assigning Subcommittees of its members to study and discuss fully exposure documents proposing additions to or revisions of auditing and attest standards. The Subcommittee ordinarily develops a proposed response that is considered, discussed and voted on by the full Committee. Support by the full Committee then results in the issuance of a formal response, which at times includes a minority viewpoint. Current members of the Committee and their business affiliations are as follows:

Public Accounting Firms:	
Large:	
Dolinar, James A. CPA	Crowe Chizek & Co. LLP
Gabouer, Kurt CPA	KPMG LLP
Graf, William P. CPA	Deloitte & Touche LLP
Graham, G. W., CPA	Grant Thornton LLP
McClanahan, James P. CPA	Altschuler, Melvoin & Glasser LLP
Pierce, Michael J. CPA	American Express Tax & Business Services
Waggoner, Joan, CPA	Blackman Kallick Bartelstein LLP
Medium: (more than 40 employees)	
Gregor, Sharon J. CPA	Selden, Fox and Associates, Ltd.
Mills, Gary W., CPA	KGN Financial Group LLC
Panfil, Stephen R. CPA	Bansley & Kiener LLP
Small: (less than 40 employees)	
Davila, Antonio Jr. CPA	Hill, Taylor LLC
Goltz, Jeffrey M. CPA	Rosen, Goltz & Associates
Kramer, Loren B. CPA	Kramer Consulting Services, Inc.
Krueger, Andrea L., CPA	Corbett, Duncan & Hubly P.C.
Lewis, Ludella, CPA	Ludella Lewis & Company
Malito, JoAnne M., CPA	McGreal, Johnson and McGrane
Owens, Robert W. CPA	Wermer, Rogers, Doran & Ruzon
Spiegel, Richard D., CPA	Steinberg Advisors, Ltd.
Industry:	
Hunt, Brian J. CPA, JD	Williams Montgomery & John, Ltd.
Adler, James R. CPA, CFE, PhD	Adler Consulting, Ltd.
Government:	
Bailey, Scott P. CPA	Metropolitan Pier & Exposition Authority
Educators:	
Petravick, Simon P. CPA	Bradley University
Whittington, Oliver R., CPA	DePaul University
Staff Representative:	
C. Patricia Mellican, CPA	Illinois CPA Society

INDEPENDENT COMMUNITY BANKERS *of* AMERICA

November 20, 2003

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

Re: PCAOB Rulemaking Docket No. 008: Proposed Auditing Standard-An Audit of Internal Control Over Financial Reporting

Dear Sir/Madam:

The Independent Community Bankers of America (ICBA)[1] appreciates the opportunity to offer the following comments on proposed auditing standards by the Public Company Accounting Oversight Board (PCAOB). If adopted, these standards will be the required standards that auditors must follow when they attest to the internal controls of companies subject to the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley).

While ICBA commends the PCAOB on its attempt to establish standards for auditors when they are performing audits of internal control, ICBA is concerned that the proposed standards will be burdensome and costly for community banks and bank holding companies that are either (1) publicly-held and are subject to Sarbanes-Oxley, or (2) have assets of $500 million or more and therefore are subject to the internal control attestation requirements of Section 36 of the FDI Act as implemented by Part 363 of the FDIC's regulations. Those regulations require a covered financial institution's independent public accountant to examine, attest to, and report separately on management's assertion concerning internal controls. The banking agencies have indicated that the PCAOB's auditing standards for internal controls under Section 404 of Sarbanes-Oxley will most likely be the standards that auditors must follow when they audit the internal controls of financial institutions that have assets of $500 million or more.

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[1] *ICBA is the nation's leading voice for community banks and the only national trade association dedicated exclusively to protecting the interests of the community banking industry. ICBA has 4,600 members with branches in more than 17,000 locations nationwide. Our members hold more than $526 billion in insured deposits, $728 billion in assets and more than $405 billion in loans for consumers, small businesses, and farms. They employ more than 231,000 people in the communities they serve.*

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ICBA is concerned that auditing costs will rise substantially if the proposed standards for internal control audits are adopted by the PCAOB. Several community banks have already filed notice with the SEC this year that they intend to withdraw registration of their securities and go private. One of the primary reasons cited by these banks is the higher auditing costs associated with being a publicly-held company subject to Sarbanes-Oxley. ICBA offers the following responses to some of the questions raised in the proposal:

Question 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?

The Board says that it is "sensitive to the possible effects of the proposed standard on small and medium-sized companies" and that the "nature and extent of controls that are necessary depend, to a great extent, on the size and complexity of the company." However, the Board does not make any specific recommendations for how audits of internal accounting controls should be conducted by small and medium-sized companies. Appendix E, which is entitled "Special Internal Control Over Financial Reporting Considerations for Small and Medium-Sized Companies" offers very little in the way of concrete suggestions for reducing the auditing required of small and medium-sized companies. In ICBA's opinion, the Board should specifically recommend that auditors of smaller companies rely more on sampling and less on extensive testing. For example, Appendix E should say that walkthroughs and other kinds of testing should only be required of a sample of "significant processes" rather than all of them. Such specific suggestions would reduce the costs of audits for small and medium sized companies.

Question 10. Is it appropriate to require 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?

No, it is not appropriate to require that the walkthroughs be performed only by the outside auditor. If a company has an internal audit staff that follows professional auditing standards and reports directly to the audit committee, the auditor should be able to rely on the walkthroughs performed by the internal auditors. It would be very expensive to require external auditors to duplicate all the tasks that are done by the internal auditors.

Question 11. Is it appropriate to require the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year or may the auditor use the audit evidence obtained in previous years to support his or her current opinion on management's assessment?

While each auditor must obtain whatever evidence is necessary to provide a basis for an opinion, generally, an auditor should be able to use the audit evidence obtained in previous years to support his or her current opinion on management's assessment. Otherwise, if the auditor has to obtain evidence yearly in every case, audit costs will be substantial. Furthermore, public accounting firms should be attesting to the assessment made by management about internal controls. They should be testing controls and procedures to the extent necessary to corroborate management's assessment of the internal controls and not be performing a detailed audit of internal controls each year.

Questions 22 and 23. 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? Will the auditors be able to effectively evaluate the effectiveness of the audit committee's oversight?

ICBA believes that it would be costly and impractical to require the outside auditors to audit the audit committee. Under Sarbanes-Oxley, the audit committee has the responsibility to hire the outside auditors, approve non-audit services, and resolve disagreements between the auditors and management regarding financial reporting. It would pose a conflict to the auditors if they were then required to audit the audit committee. While auditors should have access to the audit committee members and, in some cases, to their records, the board of directors should evaluate the effectiveness of the audit committee, not the outside auditors.

Conclusion

ICBA hopes that the PCAOB will consider the costs of performing audits particularly for small and medium-sized companies as it establishes standards for auditors and audits. While we commend the Board for its efforts so far, we hope the Board will be more cost conscious with its proposals in the future. If you have any questions or need any additional information, please contact Chris Cole, ICBA's regulatory counsel at 202-659-8111 or Chris.Cole@icba.org.

Sincerely,

C. R. Cloutier

C.R. Cloutier
Chairman

Information Systems Audit and Control Association®

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November 21, 2003

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Via E-mail to comments@pcaobus.org

RE: PCAOB Rulemaking Docket Matter No. 008
PCAOB Release No. 2003-017, October 7, 2003
(Proposed Auditing Standard – An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements)

Dear Board Members:

We very much appreciate the opportunity to provide comments to the Public Company Accounting Oversight Board's ("Board" or "PCAOB") proposed auditing standard. These comments are offered on behalf of the Information Systems Audit and Control Association (ISACA) and IT Governance Institute (ITGI), in my capacity as the International President of both of these organizations.

ISACA is an international professional, technical and educational organization dedicated to being a recognized global leader in IT governance, security, control and assurance. With members in more than 100 countries, ISACA is uniquely positioned to fulfill the role of a central, harmonizing source of IT control practice standards the world over. Its strategic alliances with other organizations in the financial, accounting, auditing and IT professions ensure an unparalleled level of integration and commitment by business process owners.

ITGI strives to assist enterprise leaders in their responsibility to make IT successful in supporting the enterprise's mission and goals. Its goals are to raise awareness and understanding among, and provide guidance and tools to, boards of directors, executive management and chief information officers (CIOs). The ultimate goal is to ensure that IT meets and exceeds expectations, and its risks are mitigated.

Taken as a whole, we support the draft standard and what it sets out to accomplish. We list below our comments on some of the areas covered in the draft standard. We have made comments in 4 areas:

- IT Controls—We suggest clarification of some of the IT control-related terminology used in the standard.

- IT Control Framework—We suggest an alternative view of IT controls using the *Control Objectives for Information and related Technology* (COBIT) as a formal guidance framework.
- Reliance on IT Internal Audit—We suggest revisiting this area and allowing public accounting firms to rely on the work of IT internal audit.
- Audit Committee Effectiveness—We suggest that additional definition regarding the role of the audit committee in the IT governance area be provided, and that the IT Governance Institute be used as a resource for this.

IT Controls

We note that "IT general controls" are referred to throughout the proposed standard. However, the scope of the IT general controls is not defined. We are concerned that organizations and auditors may focus on only the control activities component of general controls defined in COSO, i.e., "General controls commonly include controls over data center operations, system software acquisition and maintenance, access security, and application system development and maintenance." We explain below what we feel is a more comprehensive view of IT controls.

We also noted an inconsistency and lack of clarity in the references to application controls within the draft standard. We feel that this should be addressed as well, and provide below a view on how this could be accomplished.

If the scope of IT general and application controls is not further clarified, then there is an increased risk that organizations and their auditors will not consider the entire IT governance framework in their evaluation of the effectiveness of the financial reporting control framework. We believe that further clarification and definition of the term "certain information technology general controls" used within the document should be considered. Once again, we offer the alternative detailed below to cover this concern.

As noted in our recent publication, *IT Control Objectives for Sarbanes-Oxley*, which we have attached to this submission, IT controls apply to all COSO components, not just the control activities component. We believe that the Board may want to consider referencing COBIT within the final guidance, as a framework for the IT control environment, much as COSO has been recommended as the internal control framework (see the Framework section below for further clarification).

COSO identifies five essential components of effective internal control. Below, we highlight, in each of the five COSO component areas, our rationale for requesting further clarification be provided within the standard, by referring to COBIT as the IT control framework. A description of the relationship of IT to all five COSO components follows.

1. Control Environment
   The control environment primarily addresses the company level. However, IT frequently has characteristics that may require additional emphasis on business alignment, roles and responsibilities, policies and procedures, and technical competence. The following list describes some considerations related to the control environment and IT:

- IT is often mistakenly regarded as a separate organization of the business and thus a separate control environment.
- IT is complex, not only with regard to its technical components but also in how those components integrate into the company's overall system of internal control.
- IT can introduce additional or increased risks that require new or enhanced control activities to mitigate successfully.
- IT requires specialized skills that may be in short supply.
- IT may require reliance on third parties where significant processes or IT components are outsourced.
- The ownership of IT controls may be unclear.

2. Risk Assessment
   It is likely that internal control risks could be more pervasive in the IT organization than in other areas of the company. Risk assessment may occur at the company level (for the overall organization) or at the activity level (for a specific process or business unit). At the company level, the following may be expected:
   - An IT strategy subcommittee of the company's overall Sarbanes-Oxley steering committee, with the following responsibilities:
     - Oversight of the development of the IT internal control strategic plan, its effective and timely execution/implementation, and its integration with the overall Sarbanes-Oxley compliance plan
     - Assessment of IT risks, e.g., data integrity, security, confidentiality and availability

   At the activity level, the following may be expected:
   - Risk assessments built throughout the systems development methodology
   - Risk assessments built into the infrastructure operation and change process
   - Risk assessments built into the program change process

3. Control Activities
   Control activities primarily address the activity level. Without reliable information systems and effective IT control activities, public companies would not be able to generate accurate financial reports. As general and application controls increasingly replace manual controls, IT general and application controls are becoming more important.

4. Information and Communication
   COSO states that information is needed at all levels of an organization to run the business and achieve the entity's control objectives. However, the identification, management and communication of relevant information represent an ever-increasing challenge to the IT department. Supporting the other four components of the COSO framework, are the determination of which information is required to achieve control objectives and the communication of this information in a form and time frame that allow people to carry out their duties. The IT organization processes most financial reporting information. However, its scope is usually much broader. For example, the

IT department may also assist in implementing mechanisms to identify and communicate significant information or events, such as regulatory reporting or accounting disclosures.

5. Monitoring
   Monitoring, which covers the oversight of internal control by management through continuous and point-in-time assessment processes, is becoming increasingly important to IT management. There are two types of monitoring activities: continuous monitoring and separate evaluations. IT performance and effectiveness are increasingly monitored using performance measures that indicate if an underlying control is operating effectively. Consider the following examples:
   - Defect identification and management—Establishing metrics and analyzing the trends of actual results against metrics can provide a basis for understanding the underlying reasons for processing failures. Correcting these causes can improve system accuracy, completeness of processing and system availability.
   - Security monitoring—Building an effective IT security infrastructure reduces the risk of unauthorized access. Improving security can reduce the risk of processing unauthorized transactions and generating inaccurate reports, and can ensure a reduction of the availability of key systems if applications and IT infrastructure components have been compromised.

   At the company level, the following may be expected:
   - Centralized continuous monitoring of computer operations
   - Centralized monitoring of security
   - IT internal audit reviews. (While the audit may occur at the activity level, the reporting of audit results to the audit committee will be at the company level.)

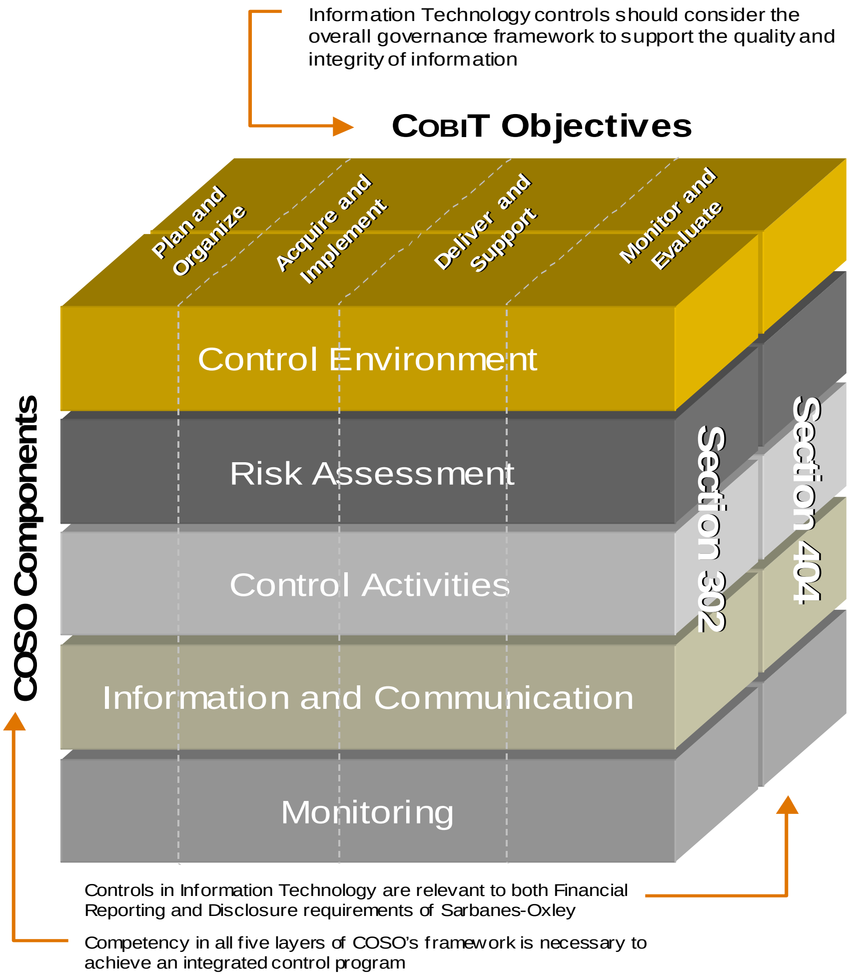
   At the activity level, the following may be expected:
   - Defect identification and management
   - Local monitoring of computer operations or security
   - Supervision of local IT personnel

IT Control Framework

We believe that, where IT is significant to the financial reporting of business enterprises, these enterprises need to use an IT control framework to supplement the overall COSO framework, as illustrated in the attached publication *IT Control Objectives for Sarbanes-Oxley*.

COBIT, originally introduced in 1996, is an open, *de facto* IT governance and control framework, now in its third edition. The framework, which is entirely compliant with COSO, is referred to and used globally by assurance and control professionals, and by business process owners and IT management. Again, we applaud the PCAOB for taking on the issues, especially as they apply to IT controls.

We would like to recommend that the Board adopt COBIT as the IT control framework. While the importance of IT control is embedded in the COSO internal control framework, IT management requires more examples to help document and evaluate controls. COBIT is an IT governance model, which provides both company-level and activity-level objectives and associated controls. Using the COBIT framework, a company can design a system of IT controls to comply with S404 of the Sarbanes-Oxley Act. The following depicts the COSO–COBIT relationship within the requirements of Sarbanes-Oxley.



Reliance on IT Internal Audit

While we agree that a public accounting firm should independently review IT controls within the IT control environment, we do have reservations about the inference that the public accountant cannot use the results of testing performed by management and others within other COSO components. IT audit professionals normally perform this testing. Many of those hold the Certified Information Systems Auditor (CISA) certification, offered by ISACA since 1978 and earned by more than 30,000 professionals worldwide. We suggest that the public accounting firm could determine the adequacy and appropriateness of such testing, based on the competence of the internal auditor and the auditor's positioning and independence, with additional testing being performed as necessary in the circumstances. If reliance cannot be placed on IT general controls testing then no credit can be given to the work that internal audit professionals are carrying out every day. We recommend that the Board consider revising this rule to provide further clarification on the reliance public accounting firms can place on the work of IT internal auditors.

Audit Committee Effectiveness
Reference paragraph 56:
"Evaluating the Effectiveness of the Audit Committee's Oversight of the Company's External Financial Reporting and Internal Control Over Financial Reporting"

The company's audit committee plays an important role within the control environment, including the monitoring components of internal control over financial reporting. Within the control environment, the existence of an effective audit committee is essential to setting a positive tone at the top. Within the monitoring component, an effective audit committee is crucial to challenging the company's activities in the financial arena.

However we do have the following comments:

- We suggest that the main issue is the effectiveness of the audit committee in overseeing corporate governance over financial reporting, which includes governance over the IT function. Additional emphasis on the spirit of the controls over IT governance should be considered.
- IT governance is such an integral part of corporate governance, including internal control, which we believe boards and the audit committee need to extend governance to IT. Doing so will in turn provide the leadership, organizational structures and processes that ensure that the enterprise's IT sustains and extends the enterprises strategies and objectives. The current environment, which encompasses the new standard and other issues the PCAOB is addressing, calls for increasing emphasis on a broader corporate governance role for audit committees. The audit committee must deal effectively with IT governance and its implications if it is to deal effectively with processes to monitor risk and ensure that the system of internal control is effective in reducing those risks to an acceptable level.
- The ITGI was created for such reasons, and has been focusing on creating and delivering seminal research to assist in the provision of solutions to deal with these issues. We feel that the ITGI can provide some value going forward to the PCAOB, especially as it deals with the overarching issues of governance and IT. Much of the research and thought-provoking work the ITGI has created is closely linked back to COBIT—the framework for IT governance and control.

Again, we appreciate the opportunity to comment on the proposed standard. Thank you for considering our views. We would be happy to discuss them with you in further detail.

Respectfully submitted,

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2003-2004 International President
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Enc. *IT Control Objectives for Sarbanes Oxley*

IT GOVERNANCE INSTITUTE®

IT Control Objectives for Sarbanes-Oxley

The importance of IT in the design, implementation and sustainability of internal control over disclosure and financial reporting

Discussion Document

IT Governance Institute®

The IT Governance Institute (ITGI) strives to assist enterprise leaders in their responsibility to make IT successful in supporting the enterprise's mission and goals. Its goals are to raise awareness and understanding among and provide guidance and tools to boards of directors, executive management and chief information officers (CIOs) such that they are able to ensure within their enterprises that IT meets and exceeds expectations, and its risks are mitigated.

Information Systems Audit and Control Association®

The Information Systems Audit and Control Association (ISACA®) is an international professional, technical and educational organization dedicated to being a recognized global leader in IT governance, control and assurance. With members in more than 100 countries, ISACA is uniquely positioned to fulfill the role of a central, harmonizing source of IT control practice standards the world over. Its strategic alliances with other organizations in the financial, accounting, auditing and IT professions ensure an unparalleled level of integration and commitment by business process owners.

Disclaimer

The IT Governance Institute, Information Systems Audit and Control Association and the authors of *IT Control Objectives for Sarbanes-Oxley* have designed this publication primarily as an educational resource for control professionals. The IT Governance Institute, Information Systems Audit and Control Association, authors and expert reviewers ("the Development Team") make no claim that use of this product will assure a successful outcome. This publication should not be considered inclusive of any proper procedures and tests or exclusive of other procedures and tests that are reasonably directed to obtaining the same results. In determining the propriety of any specific procedure or test, the controls professional should apply his/her own professional judgment to the specific control circumstances presented by the particular systems or information technology environment.

Readers should note that this document has not received endorsement from the Securities and Exchange Commission (SEC) or the Public Company Accounting Oversight Board (PCAOB). Accordingly, the Development Team makes no representation or warranties and provides no assurances that an organization's disclosure controls and procedures and the internal controls and procedures for financial reporting are compliant with the certification requirement and internal control reporting requirement of Sarbanes-Oxley, nor that an organization's plans are sufficient to address and correct any shortcomings that would prohibit the organization from making the required certification or reporting under Sarbanes-Oxley. Additional considerations are provided in the Preface of this publication.

Internal controls, no matter how well designed and operated, can provide only reasonable assurance of achieving an entity's control objectives. The likelihood of achievement is affected by limitations inherent to internal control. These include the realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human failures such as simple errors or mistakes. Additionally, controls, whether manual or automated, can be circumvented by the collusion of two or more people or inappropriate management override of internal controls.

Disclosure

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ISBN: 1-893209-67-9
Printed in the United States of America

Acknowledgements

The IT Governance Institute wishes to recognize:

The authors, for their thought leadership
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Paul A. Zonneveld, CISA, CISSP, CA, Deloitte & Touche LLP, Canada

The expert reviewers, whose comments helped shape the final document
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Sean Ballington, CISA, CA, PricewaterhouseCoopers LLP, USA
Don Caniglia, CISA, Crowe Chizek LLP, USA
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Preface

Despite all the publicity surrounding the Sarbanes-Oxley Act of 2002, relatively little attention has focused specifically on the role of information technology (IT) in the financial reporting process. This is unfortunate, given that the accuracy and timeliness of financial reporting is, at most companies, heavily dependent on a well-controlled IT environment.

IT organizations need to become involved in Sarbanes-Oxley attestation activities quickly. While the US Securities and Exchange Commission (SEC) has extended the dates for compliance with Section 404 of the Act, this move was only an acknowledgement that the original time frame was unrealistic and more time was needed for companies to comply. It was not an invitation to delay readiness and implementation work.

Accordingly, there is an urgent need for guidance material that specifically addresses the information technology control environment. This document is intended to help meet that need.

The Sarbanes-Oxley Act provides the foundation for new corporate governance rules, regulations and standards issued by the SEC.
On 7 October 2003, the Public Company Accounting Oversight Board (PCAOB) issued both a briefing paper and a proposed auditing standard, release no. 2003-17—"An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements." While this guidance has provided further clarification on the nature and extent of the work required to provide an audit opinion, there are significant rules and standards that have yet to be issued. Among others, these might include detailed guidance on documentation requirements and further clarification on the requirements for real-time disclosure. The issuance of rules, standards and guidelines will be an ongoing process that will continually adapt to the results of regulatory examinations and the changing business and accounting environments. It is likely that there will never be a time when the rules for Sarbanes-Oxley will be "black and white"; many areas will still require professional judgment and interpretation. The development of industry standards and practices and the public debate over what could be considered to be good practice should facilitate this process.

Unlike previous event-driven control activities (e.g., Y2K), Sarbanes-Oxley activity will continue as a routine part of doing business. This document focuses on the aspects of Sarbanes-Oxley that will have the greatest impact on an organization in the short to medium term, that is, compliance with Section 302 and 404 of the act. The document deliberately does not focus on operational and efficiency issues, as the first priority should be demonstrating that strong IT controls over financial reporting are in place. However, it is inevitable (and desirable) that operational and efficiency issues will be addressed over time and built into the structures and processes that are developed. Once the ongoing cost of Sarbanes-Oxley compliance is assessed, there will be pressure to replace existing manual controls and processes with automated processes. In addition, there are other aspects of Sarbanes-Oxley that may have considerable impact on IT, e.g., the potential impact of real-time disclosure.

Readers may find the material in the appendix—IT Control Objectives for Sarbanes-Oxley—particularly useful. *COSO—Internal Control—Integrated Framework* was used as the overall framework upon which the supplementary IT guidance was based. *Control Objectives for Information and related Technology* (COBIT®), established by the IT Governance Institute, was used as the initial IT controls baseline to develop a control objective template. While COBIT addresses control objectives that relate to operational and compliance issues, only those related to financial reporting have been used to develop this document.

COBIT is a very rich and robust framework, comprising four domains, 34 IT processes and 318 detailed control objectives. It is a comprehensive approach for managing risk and control of information technology. As such, the control objectives and considerations set forth in this document may exceed, or be deficient in, what is necessary for organizations seeking to comply with the requirements of Sarbanes-Oxley. The suggested internal control framework (COSO) to be used for compliance with Sarbanes-Oxley, as supported by the Securities and Exchange Commission (SEC), addresses the topic of IT general controls, but does not dictate requirements for such control objectives and related control activities. Similarly, the audit standards issued by the PCAOB on 7 October 2003 highlight the importance of IT general controls, but do not specify which in particular must be included. Such decisions remain the responsibility of an organization's management and independent auditors for their respective purposes. Accordingly, companies should assess the nature and extent of information technology controls necessary to support their internal control program on a case-by-case basis. Additional considerations are provided in the disclaimer section of this publication.

In developing this publication, the approach that was taken started with reviewing the detailed COBIT control objectives, reconciling the objectives to COSO, determining if the objectives related to financial reporting objectives, extracting the IT general control objectives and rewriting objectives, as appropriate, so that they focus on financial reporting objectives—the requirement of Sarbanes-Oxley. The resulting general control objectives framework has four domains, 27 IT processes and 136 detailed control objectives.

However, a "one size fits all" approach is not the way to proceed. Each organization may want to tailor the control objective template to fit its specific circumstances, e.g., if systems development is considered to be of low risk, an organization may choose to amend or delete some of the suggested detailed control objectives. It is further suggested that each organization consult with its external auditors to ensure that all attestation-critical control objectives are addressed. An organization may then choose to incorporate additional aspects of COBIT.

Your comments on this document are welcome. Please submit your suggestions no later than 26 November 2003 to *research@isaca.org*, referencing this document by name: IT Control Objectives for Sarbanes-Oxley. After that date, the ITGI will review all comments received, finalize and reissue the document.

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A Focus on Internal Control

Recent events have ushered in a new era in the history of business, characterized by a firm resolve to increase corporate responsibility. The Sarbanes-Oxley Act of 2002 was created to restore investor confidence in US public markets, which were devastated by business scandals and lapses in corporate governance. Although it has literally rewritten the rules for accountability, disclosure and reporting, the Act's myriad pages of legalese support a simple premise: good corporate governance and ethical business practices are no longer optional niceties—they are the law.

With the future of the capital markets—a pillar of the economy—at stake, the need to link sound corporate governance with effective internal control has never been greater. Forward-thinking companies and executives will seize the opportunity. Those who fail to act may pay a heavy price.

Sarbanes-Oxley—Enhancing Corporate Accountability

Some observers have described Sarbanes-Oxley as the most significant piece of business legislation in the last half-century. Sarbanes-Oxley fundamentally changes the business and regulatory environment, and public companies cannot afford to underestimate the task ahead. The clock is ticking on compliance, and any delays in dealing with the issue may have serious consequences. Immediate and decisive action is required.

Sarbanes-Oxley aims to enhance corporate governance through measures that will strengthen internal checks and balances and, ultimately, strengthen corporate accountability. However, it is important to emphasize that Section 404 does not merely require companies to establish and maintain an adequate internal control structure, but also to assess its effectiveness on an annual basis. This distinction is significant.

For those organizations that have begun the compliance process, it has quickly become apparent that information technology plays a vital role in internal control—supporting the systems, data and infrastructure components that are critical to the financial reporting process. On 7 October 2003, the PCAOB issued a proposed auditing standard that discusses the importance of information technology in the context of internal control. In particular it states:

> *70. The nature and characteristics of a company's use of information technology in its information system affect the company's internal control over financial reporting.*

To this end, IT professionals, especially those in executive positions, need to be well-versed in internal control theory and practice to meet the requirements of the Act. CIOs must now take on the challenges of (1) enhancing their knowledge of internal control, (2) understanding their company's overall Sarbanes-Oxley compliance plan, (3) developing a compliance plan to specifically address IT controls, and (4) integrating this plan into the overall Sarbanes-Oxley compliance plan.

Accordingly, the goal of this publication is to offer guidance to those responsible for corporate IT systems on the following:

A. Assessing the current state of their IT control environment
B. Designing control improvements necessary to meet the directives of Sarbanes-Oxley Section 404
C. Closing the gap between A and B

Specific Requirements of Sarbanes-Oxley

Much of the discussion surrounding Sarbanes-Oxley has focused on Sections 302 and 404. A brief primer can be found in **figure 1**.

Figure 1—Sarbanes-Oxley Requirements Primer

	302	404
Who	Corporate management, executives and financial officer	Corporate management, executives and financial officer
What	1. Evaluate effectiveness of disclosure controls (with focus on changes since the most recent evaluation)* 2. Evaluate changes in internal control over financial reporting 3. Disclose all known control deficiencies and weaknesses 4. Disclose acts of fraud	1. Evaluate design and operating effectiveness of internal controls over financial reporting 2. Disclose all known controls, significant deficiencies and material weaknesses 3. Disclose acts of fraud
When	Already in effect as of July 2002	Year-ends beginning on or after June 2004**
How often	Quarterly assessment by management	Annual assessment by management and independent auditors

*Annual for foreign private issuers

**Nonaccelerated filers (<US $75M) can defer to 2005

Section 302

Under Section 302, the company's principal executive officer and financial officer must personally certify—quarterly and annually—that they:

- Are responsible for disclosure controls and procedures
- Have designed (or supervised the design of) disclosure controls to ensure that material information is made known to them
- Have evaluated the effectiveness of disclosure controls and procedures and material changes in internal control over financial reporting
- Have presented their conclusions regarding the effectiveness of disclosure controls
- Have disclosed to their audit committee and the independent auditors any significant control deficiencies, material weaknesses and acts of fraud that involve management or other employees who have a significant role in the company's internal control
- Have indicated in the filing any significant changes to disclosure controls
- Have disclosed in their quarterly reports any change that has (or is likely to) materially affect internal control over financial reporting

Auditor Evaluation Responsibilities

The draft audit standard issued by the PCAOB on 7 October 2003 discusses the external auditors responsibilities in regards to Section 302 in paragraphs 185 through 189. In particular it states:

> *185. The auditor's responsibility as it relates to management's quarterly certifications on internal control over financial reporting is different from the auditor's responsibility as it relates to management's annual assessment of internal control over financial reporting.*
>
> - *The auditor should perform limited procedures quarterly to provide a basis for determining whether he or she has become aware of any material modifications that, in the auditor's judgment, should be made to the disclosures about changes in internal control over financial reporting in order for the certifications to be accurate and to comply with the requirements of Section 302.*

Disclosure Controls and Procedures

Disclosure controls and procedures refer to the processes in place designed to ensure that all material information is disclosed by an organization in the reports it files or submits to the SEC. These controls also require that disclosures are complete and accurate and are recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Deficiencies in controls, as well as any significant changes to controls, must be communicated to the organization's audit committee and auditors in a timely manner. An organization's principal executive officer and financial officer must certify the existence of these controls on a quarterly basis.

Internal Control Over Financial Reporting

Internal control over financial reporting is defined by the SEC as:

"a process designed by, or under the supervision of, the registrant's principal executive and principal financial officers, or persons performing similar functions, and effected by the registrant's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

(1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the registrant;
(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the registrant are being made only in accordance with authorizations of management and directors of the registrant; and
(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a material effect on the financial statements."

186. To fulfill this responsibility, the auditor should perform, on a quarterly basis, the following procedures:

- *Inquire of management about significant changes in the design or operation of internal control over financial reporting as it relates to the preparation of annual as well as interim financial information that could have occurred subsequent to the preceding annual audit or prior review of interim financial information, and*
- *Determine, through a combination of observation and inquiry, whether significant changes in internal control over financial reporting may introduce significant deficiencies or material weaknesses in the design of internal control over financial reporting.*

Section 404

The directives of Sarbanes-Oxley Section 404 require that management provide an annual report on its assessment of internal control over financial reporting in the annual filing. This assessment must contain the following elements:

- A statement that company management is responsible for establishing and maintaining adequate internal control over financial reporting
- A statement identifying the internal control framework (such as COSO) used by management to evaluate the effectiveness of the company's internal control over financial reporting
- An assessment of the design and effectiveness of the company's internal control over financial reporting
- Disclosure of any material weaknesses in the company's system of internal control over financial reporting
- The company's independent auditor's attestation report on management's assessment of internal control over financial reporting

Auditor Attestation

An added challenge is that Section 404 requires a company's independent auditor to attest to management's assessment of its internal control over financial reporting. Not only must organizations ensure that appropriate controls (including IT controls) are in place, they must also provide their independent auditors with documentation supporting management's assessment. This includes design documentation and the documented results of testing procedures.

Under the Sarbanes-Oxley Act, standards for the auditor's attestation are now the responsibility of the PCAOB. While the 404 attestation is "as of" a specific date the draft PCAOB standard issued on 7 October 2003 specifically addresses financial reporting controls that should be in place for a period before the attestation date and controls that may operate after the attestation date. It states:

> *95. The auditor's testing of the operating effectiveness of such controls should occur at the time the controls are operating. Controls "as of" a specific date encompass controls that are relevant to the company's internal control over financial reporting "as of" that specific date, even though such controls might not operate until after that specific date.*
>
> *151. Management might be able to accurately represent that internal control over financial reporting, as of the end of the company's most recent fiscal year, is effective even if one or more material weaknesses existed during the period. To make this representation, management must have changed the internal control over financial reporting to eliminate the material weaknesses sufficiently in advance of the "as of" date and have satisfactorily tested the effectiveness over a period of time that is adequate for it to determine whether, as of the end of the fiscal year, the design and operation of internal control over financial reporting is effective.*

Management should meet with their external auditors to determine the period of time a control is required to be operating before the attestation date.

Audit Committee

The draft audit standard of 7 October 2003 specifically addresses the external auditor's evaluation of the audit committee in paragraphs 56 through 59. In particular it states:

> *56. Evaluating the Effectiveness of the Audit Committee's Oversight of the Company's External Financial Reporting and Internal Control Over Financial Reporting. The company's audit committee plays an important role within the control environment and monitoring components of internal control over financial reporting. Within the control environment, the existence of an effective audit committee is essential to setting a positive tone at the top. Within the monitoring component, an effective audit committee is crucial to challenging the company's activities in the financial arena.*

As a result, it would be advisable if the audit committee is aware of any significant activities impacting the IT environment as it relates to financial reporting.

Fraud Considerations in an Audit of Internal Control Over Financial Reporting

In the introduction to PCAOB draft audit standard of 7 October 2003, the board makes specific reference to fraud considerations:

> *Strong internal controls provide better opportunities to detect and deter fraud. For example, many frauds resulting in financial statement restatement relied upon the ability of management to exploit weaknesses in internal control. To the extent that the internal control reporting required by Section 404 can help restore investor confidence by improving the effectiveness of internal controls (and reducing the incidence of fraud), the auditing standard on performing the audit of internal control over financial reporting should emphasize controls that prevent or detect errors as well as fraud. For this reason, the proposed standard specifically addresses and emphasizes the importance of controls over possible fraud and requires the auditor to test controls specifically intended to prevent or detect fraud that is reasonably likely to result in material misstatement of the financial statements.*

Paragraphs 24 through 26 of the draft audit standard of 7 October 2003 address fraud considerations. In particular paragraph 25 states:

> *Part of management's responsibility when designing a company's internal control over financial reporting is to design and implement programs and controls to prevent, deter, and detect fraud.*

The Foundation for Reliable Financial Reporting

Information technology professionals understand the critical role that IT plays in the operations of a company. Indeed, it is difficult to imagine a successful company existing in the 21st century without some level of reliance on IT systems.

In today's environment, financial reporting processes are driven by IT systems. Such systems, whether ERP or otherwise, are deeply integrated in the initiation, recording, processing and reporting of financial transactions. As such, they are inextricably linked to the overall financial reporting process and need to be assessed, along with other important processes, for compliance with Sarbanes-Oxley.

To emphasize this point, the PCAOB draft audit standard of 7 October 2003 discusses the relationship of information technology and its importance in testing the design and operational effectiveness of internal control. In particular paragraph 41 states:

> *…controls should be tested, including controls over relevant assertions related to all significant accounts and disclosures in the financial statements. Generally, such controls include [among others]:*
>
> - *Controls, including information technology general controls, on which other controls are dependent.*

The draft audit standard continues in paragraph 67 by describing the process that auditors should follow in determining the appropriate assertions or objectives to support management's assessment:

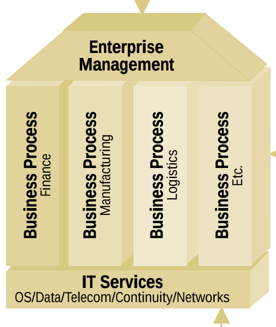
> *To identify relevant assertions, the auditor should determine the source of likely potential misstatements in each significant account. In determining whether a particular assertion is relevant to a significant account balance or disclosure, the auditor should evaluate[among others]:*
>
> - *The nature and complexity of the systems, including the use of information technology by which the company processes and controls information supporting the assertion.*

At least three common elements exist within all organizations—enterprise management, business process and shared services.

Figure 2—Common Elements of Organizations

Company-Level Controls

Company-level controls set the tone for the organization. Examples include:
- Systems planning
- Operating style
- Enterprise policies
- Governance
- Collaboration
- Information sharing
- Codes of conduct
- Fraud prevention



Application Controls

Controls embedded in business process applications, designed to achieve completeness, accuracy, validity and recording assertions, are commonly referred to as application controls. Examples include:
- Authorizations
- Approvals
- Tolerance levels
- Reconciliations
- Input edits

General Controls

Controls embedded in shared services form general controls. Examples include:
- Systems maintenance
- Disaster recovery
- Physical and logical security
- Data management
- Incident response

Enterprise Management	Business Process	Shared Services
Enterprise management is the manner in which strategy is established and incorporated into business activities. At the company level, business objectives are set, policies are established, and decisions are made on how to deploy and manage the resources of the organization. From an IT perspective, policies and other enterprisewide guidelines are set and communicated throughout the organization.	Business processes are the organization's mechanism of creating and delivering value to its stakeholders. Inputs, processing and outputs are functions of strategic business processes. Increasingly, business processes are being automated and integrated with complex and highly efficient IT systems.	Shared services are those that are required by more than one department or process and are often delivered as a common service. From an IT perspective, services such as security, telecommunications and storage are necessary services for any department or business unit, and are often managed by a central IT function.

Figure 2 demonstrates how IT controls are embedded within each element of business. For instance, consider the following areas where IT enables the controls sought for reliable financial reporting:

- Information management and data classification
- Role-based user management (authentication, initiation and authorization of transactions)
- Real-time reporting
- Transaction thresholds and tolerance levels
- Data processing integrity and validation

More and more, IT systems are automating business process activities and providing functionality that enables as much or as little control as necessary. As such, compliance programs need to include system-based controls to keep up-to-date with contemporary financial systems.

Information Technology Controls—A Unique Challenge

Sarbanes-Oxley makes corporate executives explicitly responsible for establishing, evaluating and monitoring the effectiveness of internal control over financial reporting. For most organizations, the role of information technology will be crucial to achieving this objective. Whether through a unified enterprise resource planning system or a disparate collection of operational and financial management software applications, IT is the foundation of an effective system of internal control over financial reporting.

Yet, this situation creates a unique challenge: many of the IT professionals being held accountable for the quality and integrity of information generated by their IT systems are not well versed in the intricacies of internal control. This is not to suggest that risk is not being managed by IT, but rather that it may not be formalized or structured in a way required by an organization's management or its auditors.

Organizations will need representation from IT on their Sarbanes-Oxley teams to ensure that IT general controls and application controls exist and support the objectives of the compliance effort. Some of the key areas of responsibility for IT will include:

- Understanding the organization's internal control program and its financial reporting process
- Mapping the IT systems that support internal control and the financial reporting process to the financial statements
- Identifying risks related to these IT systems
- Designing and implementing controls designed to mitigate the identified risks, and monitoring them for continued effectiveness
- Documenting and testing IT controls
- Ensuring that IT controls are updated and changed, as necessary, to correspond with changes in internal control or financial reporting processes
- Monitoring IT controls for effective operation over time

The SEC regulations that affect Sarbanes-Oxley are undeniably complicated, and implementation will be both time-consuming and costly. In proceeding with an IT control program, there are two important considerations that should be taken into account:

1. There is no need to reinvent the wheel; virtually all public companies have some semblance of IT control. While they may be informal and lacking sufficient documentation, IT controls generally exist in areas such as security and availability.
2. Many companies will be able to tailor existing IT control processes to comply with the provisions of Sarbanes-Oxley. Frequently, it is the consistency and quality of control documentation and evidential matter that is lacking, but the general process is often in place, only requiring some modification.

Performing a thorough review of IT control processes and documenting them as the enterprise moves forward will be a time-consuming task. Without appropriate knowledge and guidance, organizations will run the risk of doing too much or too little. This risk is amplified when those responsible are not experienced in the design and assessment of IT controls or lack the necessary skill or management structure to identify and focus on the areas of most significant risk.

While some industries, such as financial services, are familiar with stringent regulatory and compliance requirements of public market environments, most are not. To meet the demands of Sarbanes-Oxley, most organizations will require a change in culture. More likely than not, enhancements to IT systems and processes will be required, most notably in the design, documentation and evaluation of IT controls. Because the cost of noncompliance can be devastating to an organization, it is crucial to adopt a proactive approach and take on the challenge early.

Turning Compliance into Competitive Advantage

There is no such thing as a risk-free environment, and compliance with Sarbanes-Oxley does not create such an environment. However, the process that most organizations will follow to enhance their system of internal control to conform to the Act will undoubtedly provide lasting benefits. In particular, IT organizations can seize this opportunity to turn compliance into competitive advantage.

The work required to meet the requirements of Sarbanes-Oxley should not be regarded as a compliance process, but rather as an opportunity to establish strong governance models designed to ensure accountability and responsiveness to business requirements. Building a strong internal control program within IT can help to:

- Enhance overall IT governance
- Enhance the understanding of IT among executives

- Make better business decisions with higher-quality, more timely information
- Align project initiatives with business requirements
- Prevent loss of intellectual assets and the possibility of system breach
- Contribute to the compliance of other regulatory requirements, such as privacy
- Gain competitive advantage through more efficient and effective operations
- Optimize operations with an integrated approach to security, availability and processing integrity
- Enhance risk management competencies and prioritization of initiatives

International Considerations

Among the many factors that must be considered in complying with Sarbanes-Oxley, there are some that will uniquely impact international organizations. Specifically, global organizations, or non-US-based companies that are required to comply with Sarbanes-Oxley, need to examine their IT operations and determine if they are significant to the organization as a whole.

Significant business units can include financial business units or IT business units. The assessment of whether an IT business unit is significant can be impacted by the materiality of transactions processed by the IT business unit, the potential impact on financial reporting if an IT business unit fails and other qualitative risk factors. The issue is that there are financial materiality and significant risk considerations, quantitative and qualitative, and both aspects provide focus.

Examples of international IT assessment considerations include:

- Where the financial business units within a country are not significant individually, but IT processing occurs in a central location, then the IT business unit may be significant, e.g., a US multinational's British financial business units that are not individually significant (although they would be significant on a consolidated basis) and most financial reporting IT processing performed by a single IT business unit
- Where the financial business unit is not significant in a particular country, but the local IT business unit is responsible for regional IT processing, e.g. an IT business unit in Singapore that is responsible for IT processing throughout Asia and the Pacific
- Where there is no financial business unit in a particular country, but US-based IT responsibilities have been outsourced to that country, e.g., a US insurance company that outsources IT processing and maintenance to an IT business unit based in India

Setting the Ground Rules

Until recently, assertions on control by an organization were mostly voluntary and based on a wide variety of internal control frameworks. To improve consistency and quality, the SEC has mandated the use of a recognized internal control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment. In its final rules, specific reference is made to the recommendations of the Committee of Sponsoring Organizations of the Treadway Commission, otherwise known as COSO.[1]

COSO Defined

COSO is a voluntary, private sector organization dedicated to improving the quality of financial reporting through business ethics, effective internal control and corporate governance. It was originally formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting, an independent private sector organization often referred to as the Treadway Commission. The sponsoring organizations include the AICPA, American Accounting Association (AAA), Financial Executives International (FEI), Institute of Internal Auditors (IIA) and Institute of Management Accountants (IMA).

The sections that follow provide further insight into COSO as well as its implications for IT.

Adopting a Control Framework

For years, IT has played an important role in the operation of strategic and managerial information systems. Today, these systems are inseparable from an organization's ability to meet the demands of customers, suppliers and other important stakeholders. With widespread reliance on IT for financial and operational management systems, controls have long been recognized as necessary, particularly for significant information systems.

In the draft audit standard of 7 October 2003, the PCAOB states:

> *Because of the frequency with which management of public companies is expected to use COSO as the framework for the assessment, the directions in the proposed standard are based on the COSO framework. Other suitable frameworks have been published in other countries and likely will be published in the future. Although different frameworks may not contain exactly the same elements as COSO, they should have elements that encompass all of COSO's general themes.*

It will be important to demonstrate how IT controls support the COSO integrated framework. An organization should have IT control competency in all COSO components.

[1] *www.coso.org*

COSO identifies five essential components of effective internal control. The following is a description of each component and its relationship to IT. Detailed IT control objectives have been included at the end of this document to provide considerations for Sarbanes-Oxley compliance.

1. Control Environment

Control environment creates the foundation for effective internal control, establishes the "tone at the top," and represents the apex of the corporate governance structure. The issues raised in the control environment component apply throughout an organization.

The control environment primarily addresses the company level.

However, IT frequently has characteristics that may require additional emphasis on business alignment, roles and responsibilities, policies and procedures, and technical competence. The following list describes some considerations related to the control environment and IT:

- IT is often mistakenly regarded as a separate organization of the business and thus a separate control environment.
- IT is complex, not only with regard to its technical components but also as to how those components integrate into the company's overall system of internal control.
- IT can introduce additional or increased risks that require new or enhanced control activities to mitigate successfully.
- IT requires specialized skills that may be in short supply.
- IT may require reliance on third parties where significant processes or IT components are outsourced.
- The ownership of IT controls may be unclear.

2. Risk Assessment

Risk assessment involves the identification and analysis by management of relevant risks to achieve predetermined objectives, which form the basis for determining control activities. It is likely that internal control risks could be more pervasive in the IT organization than in other areas of the company. Risk assessment may occur at the company level (for the overall organization) or at the activity level (for a specific process or business unit).

At the company level, the following may be expected:

- An IT planning subcommittee of the company's overall Sarbanes-Oxley steering committee. Its responsibilities may include the following:
  - Oversight of the development of the IT internal control strategic plan, its effective and timely execution/implementation, and its integration with the overall Sarbanes-Oxley compliance plan
  - Assessment of IT risks, e.g., data security, availability and performance analysis

At the activity level, the following may be expected:

- Formal risk assessments built throughout the systems development methodology
- Risk assessments built into the infrastructure operation and change process
- Risk assessments built into the program change process

3. Control Activities

Control activities are the policies, procedures and practices that are put into place to ensure that business objectives are achieved and risk mitigation strategies are carried out. Control activities are developed to specifically address each control objective to mitigate the risks identified.

Control activities primarily address the activity level.

Without reliable information systems and effective IT control activities, public companies would not be able to generate accurate financial reports. COSO recognizes this relationship and identifies two broad groupings of information system control activities: general controls and application controls.

General controls, which are designed to ensure that the financial information generated from a company's application systems can be relied upon, include the following types:

- Data center operation controls—Controls such as job setup and scheduling, operator actions, backup and recovery procedures, and contingency or disaster recovery planning
- System software controls—Controls over the effective acquisition, implementation and maintenance of system software, database management, telecommunications software, security software and utilities
- Access security controls—Controls that prevent inappropriate and unauthorized use of the system
- Application system development and maintenance controls—Controls over the development methodology, which include system design and implementation, outlining specific phases, documentation requirements, approvals, and checkpoints to control the development or maintenance of the project

The draft audit standard of 7 October 2003 from the PCAOB specifically precludes the external auditor from using the results of certain information technology general controls testing performed by management and others as well as any work related to companywide antifraud programs. The previously mentioned controls are those on which the operating effectiveness of other controls depend.

Application controls are embedded within software programs to prevent or detect unauthorized transactions. When combined with other controls, as necessary, application controls ensure the completeness, accuracy, authorization and validity of processing transactions. Some examples of application controls include:

- Balancing control activities—These controls detect data entry errors by reconciling amounts captured either manually or automatically to a control total. For example, a company automatically balances the total number of transactions processed and passed from its online order entry system to the number of transactions received in its billing system.
- Check digits—Calculations to validate data. A company's part numbers contain a check digit to detect and correct inaccurate ordering from its suppliers. Universal product codes include a check digit to verify the product and the vendor.
- Predefined data listings—Provide the user with predefined lists of acceptable data. For example, a company's intranet site might include drop-down lists of products available for purchase.
- Data reasonableness tests—Compare data captured to a present or learned pattern of reasonableness. For example, an order to a supplier by a home renovation retail store for an unusually large number of board feet of lumber may trigger a review.
- Logic tests—Include the use of range limits or value/alphanumeric tests. For example, credit card numbers have a predefined format.

General controls are needed to support the functioning of application controls, and both are needed to ensure accurate information processing and the integrity of the resulting information used to manage, govern and report on the organization. As application controls increasingly replace manual controls, general controls are becoming more important.

4. Information and Communication

COSO states that information is needed at all levels of an organization to run the business and achieve the entity's control objectives. However, the identification, management and communication of relevant information represents an ever-increasing challenge to the IT department. The determination of which information is required to achieve control objectives, and the communication of this information in a form and time frame that allows people to carry out their duties, supports the other four components of the COSO framework.

The IT organization processes most financial reporting information. However, its scope is usually much broader. For example, the IT department may also assist in implementing mechanisms to identify and communicate significant events, such as e-mail systems or executive decision support systems.

COSO also notes that the quality of information includes ascertaining whether the information is:

- Appropriate—Is it the right information?
- Timely—Is it available when required and reported in the right period of time?
- Current—Is it the latest available?
- Accurate—Are the data correct?
- Accessible—Can authorized individuals gain access to it as necessary?

At the company level, the following may be expected:

- Development and communication of corporate policies
- Development and communication of reporting requirements, including deadlines, reconciliations, and the format and content of monthly, quarterly and annual management reports
- Consolidation and communication of financial information

At the activity level, the following may be expected:

- Development and communication of standards to achieve corporate policy objectives
- Identification and timely communication of information to assist in achieving business objectives
- Identification and timely reporting of security violations

5. Monitoring

Monitoring, which covers the oversight of internal control by management through continuous and point-in-time assessment processes, is becoming increasingly important to IT management. There are two types of monitoring activities: continuous monitoring and separate evaluations.

IT performance and effectiveness are increasingly monitored using performance measures that indicate if an underlying control is operating effectively. Consider the following examples:

- Defect identification and management—Establishing metrics and analyzing the trends of actual results against metrics can provide a basis for understanding the underlying reasons for processing failures. Correcting these causes can improve system accuracy, completeness of processing and system availability.
- Security monitoring—Building an effective IT security infrastructure reduces the risk of unauthorized access. Improving security can reduce the risk of processing unauthorized transactions and generating inaccurate reports, and can ensure a reduction of the availability of key systems if applications and IT infrastructure components have been compromised.

An IT organization also has many different types of separate evaluations, including:

- Internal audits
- External audits

- Regulatory examinations
- Attack and penetration studies
- Independent performance and capacity analyses
- IT effectiveness reviews
- Control self-assessments
- Independent security reviews
- Project implementation reviews

At the company level, the following may be expected:
- Centralized continuous monitoring of computer operations
- Centralized monitoring of security
- IT internal audit reviews (While the audit may occur at the activity level, the reporting of audit results to the audit committee will be at the company level.)

At the activity level, the following may be expected:
- Defect identification and management
- Local monitoring of computer operations or security
- Supervision of local IT personnel

Assessing the Readiness of IT

Sarbanes-Oxley now requires *all* qualifying SEC-registered organizations to document, evaluate, monitor and report on internal control over financial reporting and disclosure controls and procedures, which include IT controls. The first step in this process will be to assess the overall strength of IT control in the organization by considering the questions illustrated in **figure 3**.

Figure 3—Sarbanes-Oxley IT Diagnostic Questions
1. Does the Sarbanes-Oxley steering committee understand the risks inherent in IT systems and their impact on compliance with Section 404?
2. Does IT management understand the financial reporting process and its supporting systems?
3. Does the CIO have an advanced knowledge of the types of IT controls necessary to support reliable financial processing?
4. Are policies governing security, availability and processing integrity established, documented and communicated to all members of the IT organization?
5. Are the IT department's roles and responsibilities related to Section 404 documented and understood by all members of the department?
6. Do members of the IT department understand their roles, do they possess the requisite skills to perform their job responsibilities relating to internal control, and are they supported with appropriate skill development?
7. Is the IT department's risk assessment process integrated with the company's overall risk assessment process for financial reporting?
8. Does the IT department document, evaluate and remediate IT controls related to financial reporting on an annual basis?
9. Does the IT department have a formal process in place to identify and respond to IT control deficiencies?
10. Is the effectiveness of IT controls monitored and followed up on a regular basis?

The responses to these questions will help determine (1) if the IT department is integrated with the overall Sarbanes-Oxley Section 404 implementation plan, (2) if the IT department has documented and evaluated IT controls and (3) if executive management, including the CIO, appreciates the impact that the IT department has on Sarbanes-Oxley Section 404 compliance.

Establishing IT Control Guidelines for Sarbanes-Oxley

While the importance of IT controls is embedded in the COSO internal control framework, IT management requires more examples to help identify, document and evaluate IT controls.

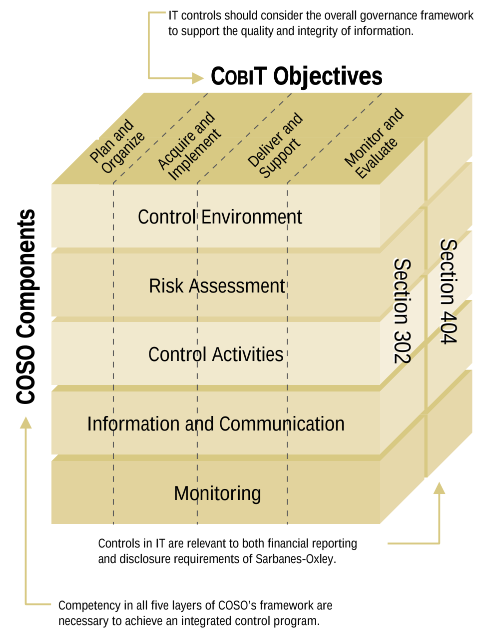
Several IT internal control frameworks exist. However, the IT control objectives known as COBIT are considered particularly useful, and are an open framework, which aligns with the spirit of the Sarbanes-Oxley requirement that any framework used be open and generally acceptable. COBIT is an IT governance model that provides both company-level and activity-level objectives along with associated controls. Using the COBIT framework, a company can design a system of IT controls to comply with Section 404.

Before deciding to use COBIT as the basis for developing the IT control objectives considered in this research, consideration was also given to other IT control guidelines—including ISO17799, the Information Technology Infrastructure Library (ITIL) and the Common Criteria—to ensure that important general and application controls necessary to satisfy Sarbanes-Oxley were addressed.

In the development of this IT control template, each control objective was challenged to ensure its relevance and importance to the requirements of Sarbanes-Oxley. This process of evaluation resulted in some COBIT control objectives being excluded or combined into a single objective, for simplicity purposes. Furthermore, each IT control objective has been reconciled to COSO, to support alignment with an organization's overall Sarbanes-Oxley program.

While COSO identifies five components of internal control (as illustrated in **figure 4**) that need to be in place and integrated to achieve financial reporting and disclosure objectives, COBIT provides similar guidance for IT. The five components of COSO—beginning with identifying the control environment and culminating in the monitoring of internal controls—can be visualized as the horizontal layers of a three-dimensional cube with the COBIT objective domains—from Plan/Organize through Monitor/Evaluate—applying to each individually and in aggregate.

Figure 4—Internal Control Components



Closing the Gap

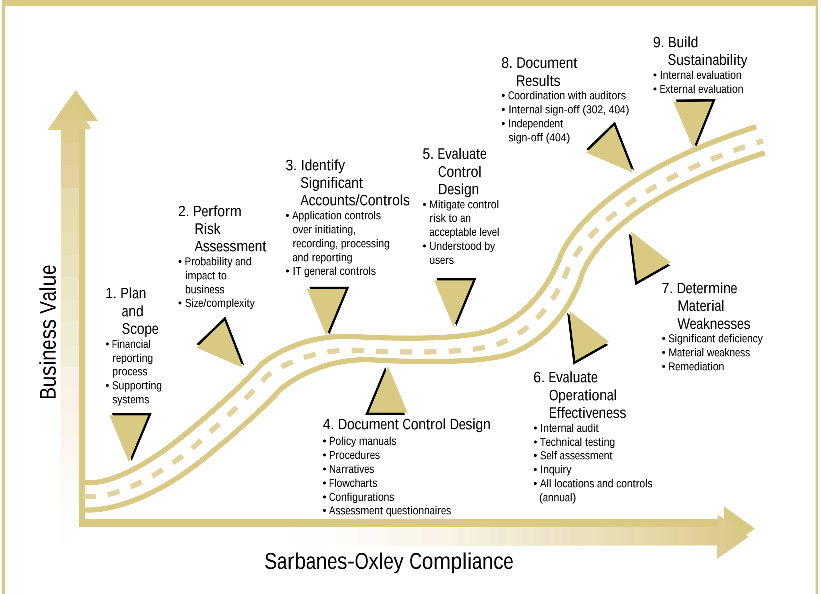
The following section provides a compliance road map that is tailored to the specific objectives and responsibilities of IT departments.

Road Map for Compliance

Understanding how Sarbanes-Oxley applies to a company—based on its business characteristics—can aid in the development of the internal control program. Many factors come into play, and larger companies will face challenges distinct from those of smaller enterprises. Also, the extent to which a strong internal control framework is already in place will have significant bearing on activities.

The compliance road map, illustrated in **figure 5**, provides direction for IT professionals on meeting the challenges of Sarbanes-Oxley.

Figure 5—Compliance Road Map



1. Plan and Scope

Scoping the project is, without question, one of the most important activities in the entire program. While it is true that general controls cut across geographies and business processes, not all IT processes are relevant.

In this project initiating phase, organizations should form an IT control subcommittee that is integrated into and reports to the overall Sarbanes-Oxley steering committee. Smaller organizations may be able to redeploy, on a part-time basis, existing staff; however, larger organizations may need dedicated full-time personnel.

As a critical first step, organizations must understand how the financial reporting process works and identify where technology is critical in the support of this process. This will identify key systems and subsystems that need to be included in the scope of the project. Typically, systems will be considered in scope, if they participate in the initiation, recording, processing and reporting of financial information.

As defined in paragraph 43 of the draft audit standard of 7 October 2003 from the PCAOB, processes and controls to be included in the scope of the program generally include:

- *Controls over initiating, recording, processing, and reporting significant accounts and disclosures and related assertions embodied in the financial statements.*
- *Controls over the selection and application of accounting policies that are in conformity with generally accepted accounting principles.*
- *Antifraud programs and controls.*
- *Controls, including information technology general controls, on which other controls are dependent.*
- *Controls over significant nonroutine and nonsystematic transactions, such as accounts involving judgments and estimates.*
- *Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; to initiate, record, and process journal entries in the general ledger; and to record recurring and nonrecurring adjustments to the financial statements (e.g., consolidating adjustments, report combinations, and reclassifications).*

2. Perform Risk Assessment

Risk assessment enables organizations to understand how events can inhibit the achievement of business objectives. Risk assessment requires two perspectives: likelihood and impact. Likelihood reflects the potential for events to occur, while impact reflects the effect of such events.

In the context of the IT compliance program, a risk assessment must be performed for systems supporting the financial reporting process. Examples of risks that could undermine financial reporting include failures of:

- The quality and integrity of information managed by IT systems
- Access controls over IT systems and related applications
- Authorizations designed and automated into application systems
- The availability and timeliness of information
- The confidentiality of information disclosure
- Recoverability controls designed to support continued reporting

Consideration must also be given to the relative financial and operational significance of various IT processing locations or business units. In some cases, the outsourcing or centralization of general IT controls may be significant to the business. In this way, compliance teams should understand the probability and impact of failures at each significant location and their potential impact to the overall organization.

Although a location or business unit may not be significant from a financial standpoint, it may still be an important location. For example, a business unit could be responsible for critical online processing, and from an IT perspective, be dependent on local systems for continuous operation. The nature of these operations could have a material impact on the organization and potentially expose it to a risk of material misstatement, even though the relative financial significance is not great. In such an event, consideration of IT controls at this location would be appropriate.

When determining which locations or business units to include in the scope of the Sarbanes-Oxley program, organizations should consider the following:

- The extent of dependence on IT at the various locations or business units
- The degree of consistency in process and procedures with other locations or business units. Where processes and procedures are unique, organizations may need to consider these locations separately and ensure that overall control objectives are met.
- The organization's assessment of risk related to the location or business unit

3. Identify Significant Accounts/Controls

COSO identifies two broad groupings of information system control activities:

- Application controls, which apply to the business processes they support, and are designed within the application to prevent/detect unauthorized transactions. When combined with manual controls, as necessary, application controls ensure completeness, accuracy, authorization and validity of processing transactions.
- General controls, which apply to all information systems and support secure and continuous operation

For application controls, organizations should first identify significant accounts that could have a material impact on the financial reporting and disclosure process. Once the significant accounts have been identified, application controls relevant to such accounts should be identified and documented.

For information technology general controls, organizations should assess those controls that support the quality and integrity of information, and that are designed to mitigate the identified risks.

The appendix of IT Control Objectives for Sarbanes-Oxley, provides details on the specific control objectives that should be considered for both general and application controls. Since company-level controls are primarily related to the control environment and risk assessment components of COSO, and their existence sets the tone for the effectiveness of all other controls, assessing company-level controls is a key objective for this phase. It includes such elements as:

- Tone from the top
- Integrity, ethical values and competence
- IT management's philosophy and operating style
- Delegation of authority and responsibility for IT management
- IT policies and procedures
- The quality and skill of people involved with the organization
- The direction provided by senior management

4. Document Control Design

Documentation is a unique aspect to the Sarbanes-Oxley compliance process that will likely pose a significant challenge for organizations. While most companies have controls in place, few have documentation to provide sufficient evidence of their design and operation.

While the PCAOB has not given detailed guidance on documentation requirements, it states in the draft standard that documentation should be sufficient for the external auditor to review the design and test the effectiveness of a control.

The draft standard addresses documentation in paragraphs 43 through 47. In addition to stating that documentation should include the five components of internal control over financial reporting, the draft standard states:

> *44. Documentation might take many forms of presentation and can include a variety of information, including policy manuals, process models, flowcharts, job descriptions, documents, and forms. No one form of documentation is required, and the extent of documentation will vary depending on the size, nature, and complexity of the company.*
>
> *45. Documentation of the design of controls over relevant assertions related to significant accounts and disclosures is evidence that controls related to management's assessment about the effectiveness of internal control over financial reporting, including changes to those controls, have been identified, are capable of being communicated to those responsible for their performance, and are capable of being monitored by the company. Such documentation also provides the foundation for appropriate communication concerning responsibilities for performing controls and for the company's evaluation of and monitoring of the effective operation of controls.*

46. Inadequate documentation of the design of controls over relevant assertions related to significant accounts and disclosures is a deficiency in the company's internal control over financial reporting.

Management should discuss the proposed extent and detail of their control documentation with their external auditors early in the process to reduce the risk that the external auditor will consider their control documentation deficient.

Understanding control theory and the concepts that define "IT control design" will be an important competency of IT organizations in the future. Put simply, IT control design defines the approach an organization follows to reduce IT risk—the risk that IT prevents the business from achieving its objectives—to an acceptable level. Once the control is properly designed, its implementation and continued effectiveness become the focus. The existence of controls and their effectiveness are discussed in subsequent phases.

Equally important in this phase is the documentation that supports an organization's control program. Documentation should be prepared—both at the company level as well as the activity level—of the objectives that the controls are designed to achieve to support the organization's internal control over financial reporting and disclosure controls and procedures.

It is advisable that an organization document its approach to IT control, including the assignment of authority and responsibility for IT controls as well as their design and operation.

5. Evaluate Control Design

In this phase, an IT organization must step back and evaluate the ability of its control program to reduce IT risk to an acceptable level and to ensure it is understood by users. The PCAOB draft audit standard of 7 October 2003 discusses the factors that might contribute to controls not operating effectively. In particular paragraph 74 states:

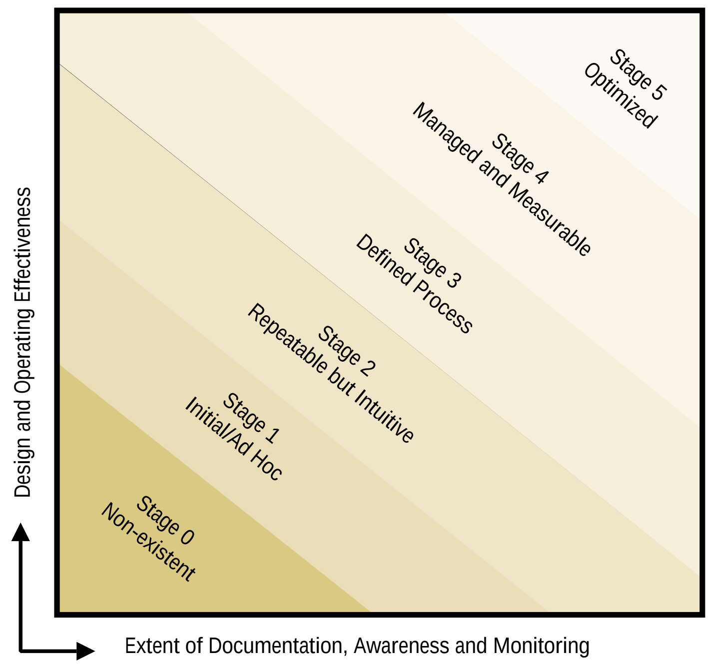
Factors that affect whether the control might not be operating effectively include the following:

- *The degree to which the control relies on the effectiveness of other controls (for example, the control environment or information technology general controls)*

To help in this process, consider the IT control design and effectiveness model in **figure 6**. Depending on how the organization measures up, it may be necessary to spend some time enhancing the design and effectiveness of the control program.

Figure 6 demonstrates the stages of control reliability that may exist within organizations. For the purposes of establishing internal control, some organizations may be willing to accept IT controls that fall somewhere short of stage 3. However, given the Act's requirements for independent attestation of controls by external audit, controls will more than likely require the attributes and characteristics of stage 3 or higher for key control activities.

Figure 6—Stages of Control Reliability



The table presented in **figure 7** provides insight into the various characteristics of each stage as well as the related implications. IT organizations must realize that there is little definition or guidance regarding the attributes or characteristics necessary to comply with the Act. The SEC has indicated that no particular form of documentation is approved or required, and the extent of documentation may vary, depending upon the size and complexity of the organization.

6. Evaluate Operational Effectiveness

Once control design has been assessed, as appropriate, its implementation and continuing effectiveness must be confirmed. During this stage, initial and ongoing tests—conducted by individuals responsible for the controls and the internal control program management team—should be performed to check on the operating effectiveness of the control activities.

Figure 7—Control Quality

	Stage 0—Non-existent	Stage 1—Initial/Ad Hoc	Stage 2—Repeatable but Intuitive	Stage 3—Defined Process	Stage 4—Managed and Measurable	Stage 5—Optimized
Characteristics	At this level, there is a complete lack of any recognizable control process or the existence of any related procedures. The organization has not even acknowledged there is an issue to be addressed and therefore no communication about the issue is generated.	There is some evidence the organization recognizes that controls and related procedures are important and that they need to be addressed. However, controls and related policies and procedures are not in place and documented. An event and disclosure process does not exist. Employees are not aware of their responsibility for control activities. The operating effectiveness of control activities is not evaluated on a regular basis. Control deficiencies are not identified.	Controls and related policies and procedures are in place but not always fully documented. An event and disclosure process is in place but not documented. Employees may not be aware of their responsibility for control activities. The operating effectiveness of control activities is not adequately evaluated on a regular basis and the process is not documented. Control deficiencies may be identified but are not remedied in a timely manner.	Controls and related policies and procedures are in place and adequately documented. An event and disclosure process is in place and adequately documented. Employees are aware of their responsibility for control activities. The operating effectiveness of control activities is evaluated on a periodic basis (e.g., quarterly), however the process is not fully documented. Control deficiencies are identified and remedied in a timely manner.	Controls and related policies and procedures are in place, adequately documented, and employees are aware of their responsibility for control activities. An event and disclosure process is in place, adequately documented and monitored, but not always re-evaluated to reflect major process or organizational changes. The operating effectiveness of control activities is evaluated on a periodic basis (e.g., weekly) and the process is adequately documented. There is limited, primarily tactical, use of technology to document processes, control objectives and activities.	Stage 5 meets all of the characteristics of stage 4. An enterprisewide control and risk management program exists such that controls and procedures are well documented and continuously reevaluated to reflect major process or organizational changes. A self-assessment process is used to evaluate the design and effectiveness of controls. Technology is leveraged to its fullest extent to document processes, control objectives and activities, identify gaps, and evaluate the effectiveness of controls.
Implications	The organization has a total inability to be in compliance at even the minimum level.	Insufficient controls, policies, procedures and documentation exist to even support management's assertion. The level of effort to document, test and remedy controls is very significant.	Although controls, policies and procedures are in place, insufficient documentation exists to support management's certification and assertion. The level of effort to document, test and remedy controls is significant.	Sufficient documentation exists to support management's certification and assertion. The level of effort to document, test and remedy controls may be significant depending on the organization's circumstances.	Sufficient documentation exists to support management's certification and assertion. The level of effort to document, test and remedy controls may be less significant depending on the organization's circumstances	Implications of stage 4 remain. Improved decision-making is enabled because of high-quality, timely information. Internal resources are used effectively and efficiently. Information is timely and reliable.

Ordinarily, organizations should test more extensively and with higher frequency those controls on which other significant controls depend (for example, general controls as opposed to application controls). In making a judgment about the extent of testing that is appropriate, organizations should consider how the IT control impacts financial and disclosure reporting processes.

The PCAOB draft audit standard of 7 October 2003 specifically addresses service auditor's reports in paragraphs B29 through B34. In particular:

> *There are a number of areas in which the auditor should not use the results of testing performed by management and others, including [among others]:*
>
> - *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.*

Some organizations use external service organizations to perform outsourced services. These services are still part of an organization's overall operations and responsibility and, consequently, need to be considered in the overall IT internal control program.

Furthermore, the PCAOB draft audit standard of 7 October 2003 states:

> *B25. The use of a service organization does not reduce management's responsibility to maintain effective internal control over financial reporting. Rather, management should evaluate controls at the service organization, as well as related controls at the company, when making its assessment about internal control over financial reporting.*

In such circumstances, organizations should review the activities of the service organization in arriving at a conclusion on the reliability of its internal control. Documentation of service organization control activities will be required for the attestation activities of the independent auditor, so an assessment is required of the service organization to determine the sufficiency and appropriateness of evidence supporting these controls.

Traditionally, audit opinions commonly known as SAS70 reports (Section 5900 in Canada) have been performed for service organizations. If these audit reports do not include tests of controls, results of the tests and the service auditor's opinion on operating effectiveness, they may not be deemed sufficient for purposes of Sarbanes-Oxley compliance. In such cases, organizations may wish to consult with their external auditors and understand the specific requirements.

7. Determine Material Weaknesses

Deficiencies in an entity's internal control range from inconsequential shortcomings to material weaknesses (see sidebar, What Is the Difference Between a Deficiency and a Weakness?). Determining whether a deficiency is significant or material requires professional judgment and the consideration of various factors.

In making the judgment as to which IT control deficiencies are significant, independent auditors will consider various factors such as the size of operations, complexity and diversity of activities, organizational structure, and the likelihood that the IT control deficiency could result in a misstatement of the organization's financial records.

To prepare, IT organizations should engage individuals with experience performing IT control audits to identify the weaknesses in IT internal control programs. Once a reliable control state has been reached, a sustainability model should be implemented to ensure its operating effectiveness over time.

8. Document Results

During the evaluation phase, results of tests performed should be recorded, as they will form the basis for management assertion and auditor attestation. Again, there is no prescribed format; the goal is to provide a comprehensive, easily understood summary of control effectiveness that is inclusive of all testing activities performed. This documentation should culminate in a management report that can be shared with senior executives and demonstrates the overall reliability, quality and integrity of IT systems. Doing so will help facilitate the CEO's and CFO's enterprisewide certifications of control.

9. Build Sustainability

The final phase ensures that internal controls are sustainable. At this point, IT management should be in a position to sign off on the IT internal control program effectiveness and the effectiveness may then be approved through an external evaluation. Control assessment and management competencies must become part of the IT department's organization and culture, and sustain themselves over the long term. Control is not an event; it is a process that requires continuous support and evaluation to stay current.

What Is the Difference Between a Deficiency and a Weakness?

An ***internal control deficiency*** may consist of a design or operating deficiency. A design deficiency exists when a necessary control is missing or an existing control is not properly designed, so that even when the control is operating as designed the control objective is not always met. An operating deficiency exists when a properly designed control either is not operating as designed or the person performing a control does not possess the necessary authority or qualifications to perform the control effectively. Internal control deficiencies relevant to internal control over financial reporting 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. Internal control deficiencies relevant to financial reporting range from inconsequential internal control deficiencies to material weaknesses in internal control.

A ***significant deficiency*** is an internal control deficiency in a significant control or an aggregation of such deficiencies that could result in a misstatement of the financial statements that is more than inconsequential.

A ***material weakness*** is a significant deficiency or an aggregation of significant deficiencies that precludes the entity's internal control from providing reasonable assurance that material misstatements in the financial statements will be prevented or detected on a timely basis by employees in the normal course of performing their assigned functions. The inability to provide such reasonable assurance results from one or more significant deficiencies. 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 errors or fraud in amounts that would be material in relation to the financial statements may occur and may not be detected within a timely period by employees in the normal course of performing their assigned functions. Therefore, the existence of a material weakness precludes the responsible party from concluding that internal control is effective and the practitioner from issuing an unqualified opinion that internal control is effective.

Note that management is not permitted to conclude that the company's internal control over financial reporting is effective, if there are one or more material weaknesses in the company's internal control over financial reporting.

How Compliance Should Be Documented

To date, most organizations have struggled with the question of how much documentation is necessary to support their internal control program, and in what form it should be retained. In responding to this query, it is important to consider the communications from the SEC and the PCAOB as well as those that will likely guide independent auditors in their certification efforts.

Documentation may take various forms, including entity policy manuals, IT policy and procedures, narratives, flowcharts, decision tables, procedural write-ups or completed questionnaires. No single particular form of documentation is mandated by Sarbanes-Oxley, and the extent of documentation may vary, depending upon the size and complexity of the organization.

For most organizations, documentation should be, at a minimum, prepared for the following:

- Company level
  - Statement of control and approach to confirming its existence and continued effectiveness over time
- Activity level
  - Description of the processes and related subprocesses (may be in narrative form; however, it may be more effective to illustrate as a flowchart)
  - Description of the risk associated with the process or subprocess, including an analysis of its impact and probability of occurrence. Consideration should be given to the size and complexity of the process or subprocess and its impact on the organization's financial reporting process.
  - Statement of the control objective designed to reduce the risk of the process or subprocess to an acceptable level and a description of its alignment to the COSO framework
  - Description of the control activity(ies) designed and performed to satisfy the control objective related to the process or subprocess
  - Description of the approach followed to confirm (test) the existence and operational effectiveness of the control activities
  - Conclusions reached about the effectiveness of controls, as a result of testing

Lessons Learned

Parallels can be drawn between the affect of the Sarbanes-Oxley Act of 2002 on public companies and the impact of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) on the banking industry.

Both statutes introduced regulations to remedy perceived market failures, and each enacted significant new reporting requirements. There are several lessons public companies can learn from the FDICIA example:

- Accept that the environment has changed profoundly. Companies must recognize that they operate in a new environment—one that demands more effort and accountability.
- Promote understanding of internal control within the organization. Companies may be tempted to show superficial compliance with Sarbanes-Oxley, but such an approach may backfire if controls fail because form was stressed over substance.
- Factor into the business model the cost of developing an internal control program. Good internal control is not a one-time expense; rather, it fundamentally changes the cost of doing business.

Past events ushered in a new era in the history of business, characterized by a firm resolve to increase corporate responsibility. Sarbanes-Oxley was created to restore investor confidence in public markets, which have been devastated by business scandals and lapses in corporate governance. Although it has literally rewritten the rules for accountability, disclosure and reporting, good corporate governance and ethical business practices are no longer optional niceties—they are the law.

To this end, IT professionals, especially those in executive positions, need to be well versed in internal control theory and practice to meet the requirements of the Act. CIOs must now take on the challenges of (1) enhancing their knowledge of internal control, (2) understanding their company's overall Sarbanes-Oxley compliance plan, (3) developing a compliance plan to specifically address IT controls and (4) integrating this plan into the overall Sarbanes-Oxley compliance plan. Unlike previous event-driven control activities (e.g., Y2K), Sarbanes-Oxley activity will continue as a routine part of doing business. IT is very important to internal control over financial reporting. Management's assessment as required by Section 404 of Sarbanes-Oxley is a complex and time-consuming project. Organizations need to develop an ongoing process to monitor compliance, as the full impact of Sarbanes-Oxley will not be known for several years.

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Appendix—IT Control Objectives for Sarbanes-Oxley

Having set the stage for the importance of IT in preparing for Sarbanes-Oxley compliance, the specific control objectives that will form the basis of the IT control program must be addressed.

The table in **figure 8** illustrates the segments of COBIT and maps their relationship to the appropriate COSO component. In reviewing this material, readers may notice that not all COBIT control objectives are mapped to the COSO framework; for instance, "identify automated solutions." In such cases, the COBIT objective has not been mapped since it has more to do with operational efficiencies than financial reporting or disclosure controls. It is immediately evident that many COBIT segment elements have relationships with more than one COSO component. This is expected, given the nature of general IT controls, as they form the basis for achieving reliable information systems. This multirelationship attribute further demonstrates why IT controls are the basis for all others and are essential for a reliable internal control program.

COBIT is a very rich and robust framework, comprising four domains, 34 IT processes and 318 detailed control objectives. It is a comprehensive approach for managing risk and control of information technology. As such, the control objectives and considerations set forth in this document may exceed, or be deficient in, what is necessary for organizations seeking to comply with the requirements of Sarbanes-Oxley. The suggested internal control framework (COSO) to be used for compliance with Sarbanes-Oxley, as supported by the Securities and Exchange Commission (SEC), addresses the topic of IT general controls, but does not dictate requirements for such control objectives and related control activities. Similarly, the audit standards issued by the PCAOB on 7 October 2003 highlight the importance of IT general controls, but do not specify which in particular must be included. Such decisions remain the responsibility of an organization's management and independent auditors for their respective purposes. Accordingly, companies should assess the nature and extent of information technology controls necessary to support their internal control program on a case-by-case basis. Additional considerations are provided in the disclaimer section of this publication.

The reader may find the following materials particularly useful. Preparing this guide is not to suggest a "one size fits all" approach; instead it recommends that each organization tailor the control objective template to fit its specific circumstances. For example, if systems development is considered to be of low risk, an organization may choose to amend or delete some of the suggested detailed control objectives. An organization may also consult with its external auditors to ensure that all attestation-critical control objectives are addressed.

An important objective of this publication is to provide IT professionals with guidance on the specific control objectives that should be considered for compliance with COSO and, ultimately, Sarbanes-Oxley. Accordingly, the following section provides this information as well as a perspective on the importance of the control segment and how it relates to COSO and financial and disclosure controls.

Figure 8—CobiT Relationship to COSO

	COSO Component				
CobiT Control Objectives	Control Environment	Risk Assessment	Control Activities	Information and Communication	Monitoring
Plan and Organize					
Define a strategic IT plan.		●		●	●
Define the information architecture.			●	●	
Determine technological direction.					
Define the IT organization and relationships.	●			●	
Manage the IT investment.					
Communicate management aims and direction.	●			●	●
Manage human resources.	●			●	
Ensure compliance with external requirements.			●	●	●
Assess risks.		●			
Manage projects.					
Manage quality.	●		●	●	●
Acquire and Implement					
Identify automated solutions.					
Acquire and maintain application software.			●		
Acquire and maintain technology infrastructure.			●		
Develop and maintain procedures.			●	●	
Install and accredit systems.			●		
Manage changes.			●		●
Deliver and Support					
Define and manage service levels.	●		●		●
Manage third-party services.	●	●	●		●
Manage performance and capacity.	●		●		
Ensure continuous service.	●		●		●
Ensure systems security.	●		●	●	●
Identify and allocate costs.					
Educate and train users.	●			●	
Assist and advise customers.					
Manage the configuration.	●		●	●	
Manage problems and incidents.			●	●	●
Manage data.			●	●	
Manage facilities.			●		
Manage operations.			●	●	
Monitor and Evaluate					
Monitor the processes.				●	●
Assess internal control adequacy.					●
Obtain independent assurance.	●				●
Provide for independent audit.					

The control objectives that follow are based on the guidance provided in COBIT. Those familiar with COBIT will recognize that the control objectives in this publication are not presented exactly as they are in COBIT. The end result is a series of IT controls, designed specifically for COSO and Sarbanes-Oxley.

As always, IT organizations should consider the nature and extent of their operations in determining which, if not all, of the control objectives need to be included in their internal control program.

1. General Controls—Plan and Organize

This domain addresses strategy and tactics, and focuses on identifying the way IT can best contribute to the achievement of the business objectives. Furthermore, the realization of the strategic vision needs to be planned, communicated and managed for different perspectives.

COBIT control processes that should be considered for COSO internal control models include:

- Define a strategic plan.
- Define the information architecture.
- Define the IT organization and relationships.
- Communicate management aims and direction.
- Manage human resources.
- Ensure compliance with external requirements.
- Assess risks.
- Manage quality.

Each of these control processes is outlined in **figures 9** through **16**.

Figure 9—Define a Strategic IT Plan

Control Objective	COSO Component
The strategic planning process is a fundamental control for IT because it provides the direction and mandate for helping the business achieve its objectives. The plan identifies what IT must do to support the business, the related risks that need to be considered by the business, the investments required to meet these objectives and sustain them over time, as well as senior management's support of the overall IT mandate. Activities performed in this area align with the risk assessment, information and communication, and monitoring components of COSO. Without appropriate IT planning, over time, the business will struggle to achieve its objectives and, the risk of noncompliance with financial reporting and disclosure requirements will increase.	
Management prepares strategic plans for IT that align business objectives with IT strategies. The planning approach includes mechanisms to solicit input from relevant internal and external stakeholders impacted by the IT strategic plans.	Risk assessment
Management obtains feedback from business process owners and users regarding the quality and usefulness of its IT plans for use in the ongoing risk assessment process.	Risk assessment
An IT planning or steering committee exists to oversee the IT function and its activities. Committee membership includes representatives from senior management, user management and the IT function.	Risk assessment
The IT organization ensures that IT plans are communicated to business process owners and other relevant parties across the organization.	Information and communication
IT management communicates its activities, challenges and risks on a regular basis with the CEO and CFO. This information is also shared with the board of directors.	Information and communication
The IT organization monitors its progress against the strategic plan and reacts accordingly to meet established objectives.	Monitoring

Figure 10—Define the Information Architecture

Control Objective	COSO Component
Information should be identified, captured and communicated in a form and time frame that enables the business to carry out its responsibilities effectively and on a timely basis. As processing deadlines become tighter and availability requirements become more important, an organization will place increasing reliance on automated, rather than manual, systems and related controls. Accordingly, the increasing demands on systems require appropriate planning and design to support these business requirements. Activities performed in this area align with the control activities and information and communication components of COSO. If information architecture is not defined or consistently applied, there is increased risk that the information required to prepare financial statements will not be available in a timely manner.	
IT management has defined information capture, processing and reporting controls—including completeness, accuracy, validity and authorization—to support the quality and integrity of information used for financial and disclosure purposes.	Information and communication
IT management has defined information classification standards in accordance with corporate security and privacy policies.	Control activities
IT management has defined, implemented and maintained security levels for each of the data classifications. These security levels represent the appropriate (minimum) set of security and control measures for each of the classifications and are reevaluated periodically and modified accordingly.	Control activities

Figure 11—Define the IT Organization and Relationships

Control Objective	COSO Component
The IT organization is responsible for managing all aspects of the system environment. Ensuring the employment of appropriate people with the necessary skills to meet the mandate of IT, and ultimately the business, is critical to its overall effectiveness. Furthermore, the definition of roles and responsibilities is necessary to establish accountability over systems and data. Activities in this area align to the control environment and information and communication components of COSO. Without appropriate skills and the definition of roles and responsibilities, there is increased risk that systems and data will not be reliable and will, thereby, compromise the business' ability to comply with legal and regulatory requirements.	
IT managers have adequate knowledge and experience to fulfill their responsibilities.	Control environment
Key systems and data have been inventoried and their owners identified.	Control environment
Roles and responsibilities of the IT organization are defined, documented and understood.	Control environment
IT personnel have sufficient authority to exercise the role and responsibility assigned to them.	Control environment
The IT organizational structure is sufficient to provide for necessary information flow to manage its activities.	Control environment
IT management has implemented a division of roles and responsibilities (segregation of duties) that reasonably prevents a single individual from subverting a critical process.	Control environment
IT management has ensured that personnel are performing only those duties stipulated in their respective jobs and position descriptions.	Control environment
IT staff evaluations are performed regularly (e.g., to ensure that the IT function has a sufficient number of competent IT staff necessary to achieve their objectives).	Control environment
Contracted staff and other contract personnel are subject to policies and procedures, created to control their activities by the IT function, to assure the protection of the organization's information assets.	Control environment
IT staff understand and accept their responsibility regarding internal control.	Control environment
IT strategies and ongoing operations are formally defined and communicated to senior management and the board of directors, e.g., through periodic meetings of an IT steering committee.	Information and communication
Significant IT events or failures, e.g., security breaches, major system failures or regulatory failures, are reported to senior management or the board.	Information and communication

Figure 12—Communicate Management Aims and Direction

Control Objective	COSO Component
Establishing a reliable system requires participation from all members of the IT organization. To accomplish this, members of the IT organization should be informed and committed to the direction of IT and its ability to meet the objectives outlined in the strategic plan. Activities in this area align to the control environment and information and communications, and monitoring components of COSO. Without communicating its direction, IT organizations may be unable to obtain the commitment of their members and, ultimately, achieve their goals.	
IT management has formulated, developed and documented policies and procedures governing the IT organization's activities.	Control environment
IT management has communicated policies and procedures governing the IT organization's activities.	Information and communication
IT management periodically reviews its policies, procedures and standards to reflect changing business conditions.	Monitoring
IT management has processes in place to investigate compliance deviations and introduce remedial action.	Monitoring
IT management has a process in place to assess compliance with its policies, procedures and standards.	Monitoring

Figure 13—Manage Human Resources

Control Objective	COSO Component
Education and training of IT staff address how an organization supports its people to perform their job responsibilities in a reliable and controlled manner. Actions performed in this area align with the control environment and information and communication components of COSO. The ability, or lack thereof, to cross-train, learn and continually enhance skill levels will directly impact the enterprise's ability to meet new challenges and demands of the business.	
Controls are in place to support appropriate and timely responses to job changes and job terminations so that internal controls and security are not impaired by such occurrences.	Control environment
The IT organization subscribes to a philosophy of continuous learning, providing necessary training and skill development to its members.	Information and communication
The IT organization adopts and promotes the entity's culture of integrity management, including ethics, business practices and human resource evaluations, to ensure compliance.	Control environment

Figure 14—Ensure Compliance with External Requirements

Control Objective	COSO Component
The organization should establish and maintain procedures to ensure compliance with Sarbanes-Oxley, the SEC and other external regulatory requirements. The compliance function should identify and communicate requirements that could potentially impact the IT organization. The IT organization should establish a framework of control to ensure that external requirements are understood and managed. If external requirements that could impact financial reporting are not addressed, then this could jeopardize accurate reporting of financial results. Activities in this area are aligned with the control activities, information and communication, and monitoring components of COSO.	
The organization monitors changes in external requirements for legal, regulatory or other external requirements related to IT practices and controls.	Monitoring
Control activities are in place and followed to ensure compliance with external requirements, such as regulatory and legal rules.	Control activities
Internal events are considered in a timely manner to support continuous compliance with legal and regulatory requirements.	Information and communication

Figure 15—Assess Risks

Control Objective	COSO Component
Risk assessment is defined as “the identification and analysis of relevant risks to achievement of the objectives.” Risk assessment is usually pervasive in the IT organization. Activities in this area align with the risk assessment component of COSO. Without adequate risk assessments, there is an increased risk that an appropriate framework of internal controls will not be implemented. An inadequate framework of internal control would jeopardize the Section 302 and 404 management assertions.	
The IT organization has an entity- and activity-level risk assessment framework, which is used periodically to assess information risk to achieving business objectives.	Risk assessment
Management’s risk assessment framework focuses on the examination of the essential elements of risk and the cause/effect relationship among them, including risks related to achieving business objectives, regulatory compliance, legal compliance, technology reliability, information integrity and human resources.	Risk assessment
A risk assessment framework exists and considers the probability and likelihood of threats.	Risk assessment
The IT organization’s risk assessment framework measures the impact of risks according to qualitative and quantitative criteria, using inputs from different areas including, but not limited to, management brainstorming, strategic planning, past audits and other assessments.	Risk assessment
The IT organization’s risk assessment framework is designed to support cost-effective controls to mitigate exposure to risks on a continuing basis, including risk avoidance, mitigation or acceptance.	Risk assessment
A comprehensive security assessment is performed for critical systems and locations based on their relative priority and importance to the organization.	Risk assessment

Figure 15—Assess Risks *(cont.)*	
Control Objective	**COSO Component**
Where risks are considered acceptable, there are formal documentation and acceptance of residual risk with related offsets, including adequate insurance coverage, contractually negotiated liabilities and self-insurance.	Risk assessment
The IT organization is committed to active and continuous risk assessment processes as an important tool in providing information on the design and implementation of internal controls, in the definition of the IT strategic plan, and in the monitoring and evaluation mechanisms.	Risk assessment

Figure 16—Manage Quality	
Control Objective	**COSO Component**
Quality programs address both general and project-specific quality assurance activities and should prescribe the type(s) of quality assurance activities (such as reviews, audits, inspections, etc.) to be performed to achieve the objectives of the general quality plan. Activities in this area align with all components of the COSO framework. Without quality assurance, the organization may not be able to rely on its systems of control, and thereby, management's 302 and 404 assertions may be jeopardized.	
Documentation is created and maintained for all significant IT processes and activities.	Control environment
A plan exists to maintain the overall quality assurance of IT activities based on the organizational and IT plans.	Control environment
Documentation standards are in place, have been communicated to all IT staff and are supported with training.	Control environment
A quality plan exists for significant IT functions (e.g., system development and deployment) and provides a consistent approach to address both general and project-specific quality assurance activities.	Control environment
The quality plan prescribes the type(s) of quality assurance activities (such as reviews, audits, inspections, etc.) to be performed to achieve the objectives of the quality plan.	Control environment
The quality assurance process includes a review of the adherence to IT policies, procedures and standards.	Control environment
Data integrity ownership and responsibilities have been communicated to the appropriate data owners and they have accepted these responsibilities.	Information and communication

2. General Controls—Acquire and Implement

This domain includes changes in and maintenance of existing systems to make sure that the life cycle is continued for these systems. To realize the IT strategy, IT solutions need to be identified, developed or acquired, as well as implemented and integrated into the business process.

COBIT control processes that should be considered for COSO internal control models include:

- Acquire and maintain application software.
- Acquire and maintain technology infrastructure.
- Develop and maintain procedures.
- Install and accredit systems.
- Manage changes.

Each of these control processes is outlined in **figures 17** through **21**.

Figure 17—Acquire and Maintain Application Software

Control Objective	COSO Component
Acquiring and maintaining application software include the design, acquisition/building and deployment of systems that support the achievement of business objectives. Actions performed in this area align with the control activities component of COSO. This is also where controls are designed and implemented to support the initiating, recording, processing and reporting of financial information and disclosure. Deficiencies in this area may have a significant impact on financial reporting and disclosure. For instance, without sufficient controls over application interfaces, financial information may not be complete or accurate. Activities in this area align with the control activities component of COSO.	
The organization has a system development life cycle methodology that considers security, availability and processing integrity requirements of the organization.	Control activities
The system development life cycle methodology ensures that information systems are designed to include application controls that support complete, accurate, authorized and valid transaction processing.	Control activities
The organization has an acquisition and planning process that aligns with its overall strategic direction.	Control activities
The organization acquires software in accordance with its acquisition and planning process.	Control activities
Procedures exist to ensure that system software is installed and maintained in accordance with the organization's requirements.	Control activities
Procedures exist to ensure that system software changes are controlled in line with the organization's change management procedures.	Control activities

Figure 18—Acquire and Maintain Technology Infrastructure	
Control Objective	**COSO Component**
Acquiring and maintaining technology infrastructure include the design, acquisition/building and deployment of systems that support applications and communications. Infrastructure components, including servers, networks and databases, are critical for secure and reliable information processing. Actions performed in this area align with the control activities component of COSO. Infrastructure controls support timely processing of financial information and also help ensure its confidentiality. Deficiencies in this area may have a significant impact on financial reporting and disclosure. For instance, without sufficient controls over network communications, financial information could be obtained and publicized without authorization.	
IT management ensures that the setup and implementation of system software do not jeopardize the security of the data and programs being stored on the system.	Control activities
Procedures exist and are followed to ensure that infrastructure systems, including network devices and software, are installed and maintained in accordance with the acquisition and maintenance framework.	Control activities
Procedures exist and are followed to ensure that infrastructure system changes are controlled in line with the organization's change management procedures.	Control activities

Figure 19—Develop and Maintain Procedures	
Control Objective	**COSO Component**
Developing and maintaining procedures include the design and implementation of service level agreements, operational practices and training materials. Actions performed in this area align with the control activities and information and communication components of COSO. Controls designed and implemented in this area support an organization's ability to perform business process activities in a consistent and objective manner. For instance, without controls to maintain consistency in how application systems generate reports, the organization may not be able to reconcile financial information in a reliable manner.	
The organization's system development life cycle methodology requires that user reference and support manuals (including documentation of controls) be prepared as part of every information system development or modification project.	Control activities
The IT organization ensures that its systems and applications are supported with documentation and processes to enable long-term sustainability and maintainability.	Information and communication

Figure 20—Install and Accredit Systems

Control Objective	COSO Component
Installation and accreditation relate to the migration of new systems into production. Before such systems are installed, appropriate testing and validation that systems are operating as designed must be performed. Activities in this area align with the control activities component of COSO. Without adequate testing, systems may not function as intended and may provide invalid information, which could result in unreliable financial information and reports.	
There exists a testing strategy for all significant changes in technology, which ensures that deployed systems operate as intended.	Control activities
Testing is performed at the unit, system, integration and user acceptance level and is included for all significant systems.	Control activities
Load and stress testing is performed according to a test plan and established testing standards.	Control activities
Interfaces with other systems are tested to confirm that data transmissions are complete, accurate and valid.	Control activities
The conversion of data is tested between its origin and its destination to confirm that it is complete, accurate and valid.	Control activities

Figure 21—Manage Changes

Control Objective	COSO Component
Managing changes addresses how an organization modifies system functionality to help the business meet its objectives. Actions performed in this area align with the control activities and monitoring components of COSO. Deficiencies in this area could significantly impact financial reporting and disclosure of an entity. For instance, changes to the accounts to which financial data are allocated require appropriate controls to ensure classification and reporting integrity.	
Requests for changes, system maintenance and supplier maintenance are standardized and are subject to formal change management procedures.	Control activities
Policies and procedures to manage emergency changes exist and are followed.	Control activities
IT management ensures that users are appropriately involved in the design of applications, selection of packaged software and the testing thereof, to ensure a reliable environment.	Control activities
Changes to systems and applications are performed in a timely manner and adhere to the organization's overall change management standards.	Control activities
Changes to IT systems and applications are performed as designed and meet the expectations of users.	Monitoring

3. General Controls—Deliver and Support

This domain deals with the actual delivery of required services, which range from traditional operations over security and continuity aspects to training. To deliver services, the necessary support processes must be set up. This domain includes the actual processing of data by application systems, often classified under application controls.

COBIT control processes that should be considered for COSO internal control models include:

- Define and manage service levels.
- Manage third-party service levels.
- Manage performance and capacity.
- Ensure continuous service.
- Ensure systems security.
- Educate and train users.
- Manage the configuration.
- Manage problems and incidents.
- Manage data.
- Manage facilities.
- Manage operations

Each of these control processes is outlined in **figures 22** through **32**.

Figure 22—Define and Manage Service Levels

Control Objective	COSO Component
Defining and managing service levels address how an organization meets the functional and operational expectations of its users and, ultimately, the objectives of the business. Roles and responsibilities are defined and an accountability and measurement model is used to ensure services are delivered, as required. Actions performed in this area align with the control activities and control environment components of COSO. Deficiencies in this area could significantly impact financial reporting and disclosure of an entity. For instance, if systems are poorly managed or system functionality is not delivered as required, financial information may not be processed as intended.	
Selection of vendors for outsourced services is performed in accordance with the organization's vendor management policy.	Control activities
A framework is defined to establish key performance indicators to manage service level agreements, both internally and externally.	Control environment

Figure 23—Manage Third-party Service Levels

Control Objective	COSO Component
Managing third-party services includes the use of outsourced service providers to support financial applications and related systems. Actions performed in this area align with the control environment, monitoring, control activities and risk assessment components of COSO. Deficiencies in this area could significantly impact financial reporting and disclosure of an entity. For instance, insufficient controls over processing accuracy by a third-party service provider may result in inaccurate financial results.	
IT management ensures that, before selection, potential third parties are properly qualified through an assessment of their capability to deliver the required service and their financial viability.	Control environment
Third-party service contracts address the risks, security controls and procedures for information systems and networks in the contract between the parties.	Control activities
Business continuity controls consider business risk related to third-party service providers in terms of continuity of service, and escrow contracts exist where appropriate.	Risk assessment
Procedures exist and are followed to ensure that a formal contract is defined and agreed to for all third-party services before work is initiated, including definition of internal control requirements and acceptance of the organization's policies and procedures.	Control activities
A designated individual is responsible for regular monitoring and reporting on the achievement of the third-party service level performance criteria.	Control activities
A regular review of security, availability and processing integrity is performed for service level agreements and related contracts with third-party service providers.	Monitoring

Figure 24—Manage Performance and Capacity

Control Objective	COSO Component
Performance and capacity support an organization's efforts to maintain complete and accurate data. They also allow an organization to trace back transactions to source information to support their validity. Activities in this area align with the control activities and monitoring components of COSO. The lack of performance and capacity could result in the financial reporting process not meeting its reporting deadlines.	
IT management monitors the performance and capacity levels of the systems.	Monitoring
IT management has a process in place to respond to suboptimal performance and capacity measures in a timely manner.	Control activities
Performance and capacity planning is included in system design and implementation activities.	Control activities

Figure 25—Ensure Continuous Service

Control Objective	COSO Component
Managing continuous service includes the ability to recover from a disaster. Controls need to be in place to manage various disaster scenarios, from backup and recovery to full business continuity. Actions performed in this area align with the control activities and monitoring components of COSO. Deficiencies in this area could significantly impact financial reporting and disclosure of an entity. For instance, the inability to recover from a disaster after year-end could prevent the organization from producing financial reports that are supported with source documentation and details of transactions that make up financial reporting balances.	
IT management, in cooperation with business process owners, has established a business continuity framework that defines the roles, responsibilities, risk-based approach/methodology to be adopted, and the approval procedures.	Control activities
The business continuity plan identifies the critical application programs, third-party services, operating systems, personnel and supplies, data files, and time frames needed for recovery.	Control activities
The IT continuity plan is aligned with the overall business continuity plan to ensure consistency.	Control activities
The IT organization's members responsible for disaster continuity plans have been trained regarding the procedures to be followed in case of an incident or disaster.	Control activities
IT management has ensured that the continuity plan is adequately tested, at least annually, and that any deficiencies are addressed within a reasonable period of time.	Control activities
Where new risks are identified, appropriate changes are made to the business continuity and disaster recovery plans.	Control activities
Offsite storage and recovery facilities are periodically assessed, at least annually, for viability, adequacy and security mechanisms.	Monitoring
A business impact assessment has been performed that considers the impact of systems failure on the financial reporting and disclosure process.	Control activities
Management has reviewed the impact assessment in determining the nature and extent of system recovery procedures necessary to support the timeliness of financial reporting and disclosure processes.	Control activities

Figure 26—Ensure Systems Security

Control Objective	COSO Component
Managing systems security includes both physical and logical controls that prevent unauthorized access. These controls typically support authorization, authentication, nonrepudiation, data classification and security monitoring. Actions performed in this area align with the control activities, information and communication, and monitoring components of COSO. Deficiencies in this area could significantly impact financial reporting. For instance, insufficient controls over transaction authorization may result in unreliable financial reporting and disclosure controls.	
An IT security plan exists that is aligned with overall IT strategic plans.	Control activities
The IT security plan is updated to reflect changes in the IT environment as well as security requirements of specific systems.	Control activities

Figure 26—Ensure Systems Security *(cont.)*	
Control Objective	**COSO Component**
Procedures exist and are followed to ensure that all users are authenticated to the system to support the validity of transactions.	Control activities
Procedures exist and are followed to maintain the effectiveness of authentication and access mechanisms (e.g., regular password changes).	Control activities
Procedures exist and are followed to ensure timely action relating to requesting, establishing, issuing, suspending and closing user accounts.	Control activities
A formal approval process exists for granting access privileges to systems and data.	Control activities
A control process exists and is followed to periodically review and confirm access rights.	Control activities
Where appropriate, controls exist to ensure that transactions cannot be denied by either party and that controls are implemented to provide nonrepudiation of origin or receipt, proof of submission and receipt of transactions.	Control activities
Where network connectivity is used, appropriate controls, including firewalls, intrusion detection and vulnerability assessments, exist and are used to prevent unauthorized access.	Control activities
The IT security plan, and its related activities and priorities, reflects results of recent security assessments.	Information and communication
The IT security administrator monitors and logs security activity, and identified security violations are reported to senior management.	Monitoring

Figure 27—Educate and Train Users	
Control Objective	**COSO Component**
Educating and training users address how an organization supports its people to perform their job responsibilities in a reliable and controlled manner. Actions performed in this area align with the control environment component of COSO. Deficiencies in this area could significantly impact financial reporting and disclosure of an entity. For instance, personnel unfamiliar with financial reporting policies may share confidential financial information with unauthorized parties, thereby undermining disclosure controls.	
The entity has established procedures for identifying and documenting the training needs of all personnel using information services in support of the long-range plan.	Control environment
IT management provides education and ongoing training programs that include ethical conduct, system security practices, confidentiality standards, integrity standards and security responsibilities of all staff.	Control environment

Figure 28—Manage the Configuration	
Control Objective	**COSO Component**
Configuration management ensures that security, availability and processing integrity controls are set up in the system and maintained through its life cycle. Activities in this area align with the control activities and monitoring components of COSO. Insufficient configuration controls can lead to security and availability exposures that may permit unauthorized access to systems and data. This would negatively impact an organization's ability to meet the internal control provisions of Section 404.	
Only authorized software is permitted for use by employees using company IT assets.	Control activities
System infrastructure, including firewalls, routers, switches, network operating systems, servers and other related devices, is properly configured to prevent unauthorized access.	Control activities
Application software and data storage systems are properly configured to provision access based on the individual's demonstrated need to view, add, change or delete data.	Control activities
IT management has established procedures across the organization to protect information systems and technology from computer viruses.	Control activities
Periodic testing and assessment is performed to confirm that software and network infrastructure is appropriately configured.	Monitoring

Figure 29—Manage Problems and Incidents	
Control Objective	**COSO Component**
Managing problems and incidents addresses how an organization identifies, documents and responds to events that fall outside of normal operations. Actions performed in this area align with the control activities and information and communication components of COSO. Deficiencies in this area could significantly impact financial reporting and disclosure of an entity. For instance, significant events such as breach of corporate security or unauthorized access to confidential information may result in a material weakness in disclosure controls.	
IT management has defined and implemented a problem management system to ensure that all operational events that are not part of the standard operation (incidents, problems and errors) are recorded, analyzed and resolved in a timely manner.	Control activities
Emergency program changes are approved, tested, documented and monitored.	Control activities
Problem escalation procedures are defined and implemented to ensure that problems are resolved in a timely manner.	Control activities
The problem management system provides for adequate audit trail facilities, which allow tracing from incident to underlying cause.	Information and communication
A security incident response process exists to support timely response and investigation of unauthorized activities.	Control activities

Figure 30—Manage Data	
Control Objective	**COSO Component**
Managing data includes the controls and procedures used to support information integrity, including its completeness, accuracy, authorization and validity. Controls are designed to support initiating, recording, processing and reporting financial information. These controls align with the control activities and information and communication components of COSO. Deficiencies in this area could significantly impact financial reporting and disclosure of an entity. For instance, without appropriate authorization controls over the initiation of transactions, resulting financial information may not be reliable.	
Data processing controls, including processing totals, are used to support the completeness and accuracy of transaction processing, authorization and validity.	Control activities
Control procedures exist for maintaining the accuracy and validity of data inputs, including edit checks, validity checks and bound checks.	Control activities
Procedures exist and are followed to manage errors in a consistent and authorized manner.	Control activities
Policies and procedures exist for the handling, distribution and retention of data and reporting output.	Control activities
Management protects sensitive information, both logically and physically, in storage and during transmission against unauthorized access or modification.	Control activities
Procedures are defined and implemented to prevent access to sensitive information stored on offline physical media, e.g., laptop computers and offsite storage.	Control activities
Retention periods and storage terms are defined for documents, data, programs, reports and messages (incoming and outgoing), as well as the data (keys, certificates) used for their encryption and authentication.	Control activities
Procedures exist to ensure that the contents of a media library containing sensitive data are inventoried and that discrepancies from physical inventory are remedied in a timely manner.	Control activities
Management has implemented a strategy for cyclical backup of data and programs.	Control activities
Procedures exist and are followed to periodically test the effectiveness of the restoration process and the quality of backup media.	Control activities
Policies and procedures exist and are followed to ensure that data retention practices meet business, legal and regulatory requirements.	Control activities
Policies and procedures exist and are followed to ensure that personally identifiable information is appropriately safeguarded and meets regulatory requirements.	Control activities
Changes to data structures are authorized, made in accordance with design specifications and are implemented in a timely manner.	Control activities
Changes to data structures are assessed for their impact on financial reporting processes.	Control activities
Procedures are in place to ensure that source documents are retained or are reproducible by the organization for an adequate amount of time to facilitate retrieval or reconstruction of data, and to satisfy legal requirements.	Information and communication

Figure 31—Manage Facilities

Control Objective	COSO Component
Physical security and related controls help IT organizations maintain the security and availability of their systems. Activities performed in this area align with the control activities component of COSO. Without controls to protect physical access to systems and infrastructure, there is an increased risk of manipulation and destruction of data, which would adversely impact an organization's ability to accurately report its financial results.	
Access to facilities is restricted to authorized personnel and requires appropriate identification and authentication.	Control activities
Physical facilities are equipped with adequate environmental controls to maintain systems and data, including fire suppression, uninterrupted power service (UPS) power backup, air conditioning and elevated floors.	Control activities

Figure 32—Manage Operations

Control Objective	COSO Component
Managing operations addresses how an organization maintains reliable application systems in support of the business to initiate, record, process and report financial information. Actions performed in this area align with the control activities and information and communication components of COSO. Deficiencies in this area could significantly impact an entity's financial reporting. For instance, lapses in the continuity of application systems may prevent an organization from recording financial transactions and, thereby, undermine its integrity.	
Management has established and documented standard procedures for IT operations, including managing, monitoring and responding to security, availability and processing integrity events.	Control activities
Controls exist to maintain processing continuity during operator shift changes by providing for the formal handover of activity, status updates and reports on current operations.	Control activities
IT management has established appropriate metrics to effectively manage the day-to-day activities of the IT department.	Control activities
System event data are sufficiently retained to provide chronological information and logs to enable the reconstruction, review and examination of the time sequences of processing.	Information and communication

4. General Controls—Monitor and Evaluate

This domain addresses management's oversight of the organization's control process and independent assurance provided by internal and external audit or obtained from alternative sources. All IT processes should be regularly assessed over time for their quality and compliance with control requirements.

Most recently, the COSO framework has been identified as meeting the framework requirements of Section 404 of the Sarbanes-Oxley Act. Under these rules, management must disclose any material weakness and will be unable to conclude that the company's internal control over financial reporting is effective if there is one or more material weakness in such control. Furthermore, the framework on which management's evaluation is based will have to be a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment.

COBIT control processes that should be considered for COSO internal control models include:
- Monitor the processes.
- Assess internal control adequacy.
- Obtain independent assurance.

Each of these control processes is outlined in **figures 33** through **35**.

Figure 33—Monitor the Processes

Control Objective	COSO Component
The collection of information aligns with the information and communication and monitoring components of COSO. If insufficient information is collected, it could impact the effectiveness of internal control assessment.	
Performance indicators (e.g., benchmarks) from both internal and external sources are defined, and data are collected and reported regarding achievement of these benchmarks.	Information and communication
IT management monitors its delivery of services to identify shortfalls and responds with actionable plans to improve.	Monitoring

Figure 34—Assess Internal Control Adequacy	
Control Objective	**COSO Component**
The monitoring of internal control relates to the monitoring component of COSO. It is a process that assesses the quality of the system's performance over time. This can be accomplished through regular management and supervisory activities. The Sarbanes-Oxley attestation process could also be viewed as a separate evaluation of internal control. A deficiency in this area could significantly impact financial reporting and disclosure controls.	
IT management monitors the effectiveness of internal controls in the normal course of operations through management and supervisory activities, comparisons and benchmarks.	Monitoring
Serious deviations in the operation of internal control, including major security, availability and processing integrity events, are reported to senior management.	Monitoring
Internal control assessments are performed periodically, using self-assessment or independent audit, to examine whether internal controls are operating satisfactorily.	Monitoring

Figure 35—Obtain Independent Assurance	
Control Objective	**COSO Component**
Independent assurance over critical IT services and activities supports management's ability to deliver reliable systems. Activities in this area align with the monitoring component of COSO. Without independent assurance, IT systems may be at risk of unauthorized access or failure. Where appropriate, IT management should assess the frequency, priority and focus of independent assurance and promptly engage in a method to prevent unexpected loss of financial and operational systems.	
IT management obtains independent reviews prior to implementing significant IT systems that are directly linked to the organization's financial reporting environment.	Monitoring
IT management obtains independent internal control reviews of third-party service providers (e.g., by obtaining and reviewing copies of SAS70, SysTrust or other independent audit reports).	Monitoring

5. Application Controls—Business Cycles

Figures 36-41 refer to controls that extend into applications and business processes that contribute to the completeness, accuracy, validity and authorization controls. These application controls are provided as examples of controls that are commonly enabled by financial and related IT systems. These objectives should not be considered an exhaustive list, but rather an example of controls that are commonly enabled by application systems. Organizations will have to consider what additional control objectives are required based on their particular industry and operating environment.

Figure 36—Application Control Objectives for the Sales Cycle

Application Control Objective	COSO Component
Application controls apply to the business processes they support. They are controls designed within the application to prevent or detect unauthorized transactions. When combined with manual controls, as necessary, application controls ensure completeness, accuracy, authorization and validity of processing transactions. For the most part, objectives presented in this section can be supported with automated application controls. They are most effective in integrated ERP environments, such as SAP, PeopleSoft, Oracle, JD Edwards and others. For nonintegrated environments, these control objectives may require a combination of manual and automated procedures.	
Orders are processed only within approved customer credit limits.	Control activities
Orders are approved by management as to prices and terms of sale.	Control activities
Orders and cancellations of orders are input accurately.	Control activities
Order entry data are transferred completely and accurately to the shipping and invoicing activities.	Control activities
All orders received from customers are input and processed.	Control activities
Only valid orders are input and processed.	Control activities
Invoices are generated using authorized terms and prices.	Control activities
Invoices are accurately calculated and recorded.	Control activities
Credit notes and adjustments to accounts receivable are accurately calculated and recorded.	Control activities
All goods shipped are invoiced.	Control activities
Credit notes for all goods returned and adjustments to accounts receivable are issued in accordance with organization policy.	Control activities
Invoices relate to valid shipments.	Control activities
All credit notes relate to a return of goods or other valid adjustments.	Control activities
All invoices issued are recorded.	Control activities
All credit notes issued are recorded.	Control activities
Invoices are recorded in the appropriate period.	Control activities
Credit notes issued are recorded in the appropriate period.	Control activities
Cash receipts are recorded in the period in which they are received.	Control activities
Cash receipts data are entered for processing accurately.	Control activities
All cash receipts data are entered for processing.	Control activities

Figure 36—Application Control Objectives for the Sales Cycle *(cont.)*

Application Control Objective	COSO Component
Cash receipts data are valid and are entered for processing only once.	Control activities
Cash discounts are accurately calculated and recorded.	Control activities
Timely collection of accounts receivable is monitored.	Control activities
The customer master file is maintained.	Control activities
Only valid changes are made to the customer master file.	Control activities
All valid changes to the customer master file are input and processed.	Control activities
Changes to the customer master file are accurate.	Control activities
Changes to the customer master file are processed in a timely manner.	Control activities
Customer master file data remain up-to-date.	Control activities

Figure 37—Application Control Objectives for the Purchasing Cycle

Application Control Objective	COSO Component
Purchase orders are placed only for approved requisitions.	Control activities
Purchase orders are accurately entered.	Control activities
All purchase orders issued are input and processed.	Control activities
Amounts posted to accounts payable represent goods received.	Control activities
Amounts posted to accounts payable represent services received.	Control activities
Accounts payable amounts are accurately calculated and recorded.	Control activities
All amounts for goods received are input and processed to accounts payable.	Control activities
All amounts for services received are input and processed to accounts payable.	Control activities
Amounts for goods or services received are recorded in the appropriate period.	Control activities
Accounts payable are adjusted only for valid reasons.	Control activities
Credit notes and other adjustments are accurately calculated and recorded.	Control activities
All valid credit notes and other adjustments related to accounts payable are input and processed.	Control activities
Credit notes and other adjustments are recorded in the appropriate period.	Control activities
Disbursements are only made for goods and services received.	Control activities
Disbursements are distributed to the appropriate suppliers.	Control activities
Disbursements are accurately calculated and recorded.	Control activities
All disbursements are recorded.	Control activities
Disbursements are recorded in the period in which they are issued.	Control activities
Only valid changes are made to the supplier master file.	Control activities

Figure 37—Application Control Objectives for the Purchasing Cycle *(cont.)*	
Application Control Objective	**COSO Component**
All valid changes to the supplier master file are input and processed.	Control activities
Changes to the supplier master file are accurate.	Control activities
Changes to the supplier master file are processed in a timely manner.	Control activities
Supplier master file data remain up-to-date.	Control activities

Figure 38—Application Control Objectives for the Monetary Cycle	
Application Control Objective	**COSO Component**
Borrowings are accurately recorded as to amounts and terms.	Control activities
All borrowings are recorded.	Control activities
Borrowings are recorded in the appropriate period.	Control activities
All interest is accurately calculated and recorded in the appropriate period.	Control activities
Recorded loan repayments are valid.	Control activities
Loan repayments are accurately recorded.	Control activities
All loan repayments are recorded.	Control activities
Loan repayments are recorded in the appropriate period.	Control activities
Investment purchases, sales and maturities are accurately recorded.	Control activities
All investment transactions are recorded.	Control activities
Investment transactions are recorded in the appropriate period.	Control activities
All investment income is accurately calculated and recorded in the appropriate period.	Control activities
Derivative transactions are accurately recorded.	Control activities
Derivative transactions are recorded in the appropriate period.	Control activities

Figure 39—Application Control Objectives for the Inventory Cycle	
Application Control Objective	**COSO Component**
All adjustments to inventory prices or quantities are recorded.	Control activities
Adjustments to inventory prices or quantities are recorded promptly and in the appropriate period.	Control activities
Adjustments to inventory prices or quantities are accurately recorded.	Control activities
All credits to inventory related to billed sales are approved by management and such approval is documented.	Control activities
Raw materials are received and accepted only if they have valid purchase orders.	Control activities
Raw materials received are accurately recorded.	Control activities
All raw materials received are recorded.	Control activities
Receipts of raw materials are recorded promptly and in the appropriate period.	Control activities

Figure 39—Application Control Objectives for the Inventory Cycle *(cont.)*	
Application Control Objective	**COSO Component**
Defective raw materials are promptly returned to suppliers.	Control activities
All transfers of raw materials to production are accurately recorded and in the appropriate period.	Control activities
All recorded production costs are consistent with actual direct and indirect expenses associated with production.	Control activities
All direct and indirect expenses associated with production are recorded as production costs.	Control activities
All direct and indirect expenses associated with production are recorded accurately and in the appropriate period.	Control activities
All transfers of completed units of production to finished goods inventory are recorded completely and accurately in the appropriate period.	Control activities
Finished goods returned by customers are recorded completely and accurately in the appropriate period.	Control activities
Finished goods received from production are recorded completely and accurately in the appropriate period.	Control activities
Goods received from production or returned by customers are accepted only in accordance with the organization's policies.	Control activities
All shipments are recorded.	Control activities
Shipments are accurately recorded.	Control activities
Shipments are recorded promptly and in the appropriate period.	Control activities
Inventory is relieved only when goods are shipped with approved customer orders.	Control activities
Costs of shipped inventory are transferred from inventory to cost of sales.	Control activities
Costs of shipped inventory are accurately recorded.	Control activities
Amounts posted to cost of sales represent those associated with shipped inventory.	Control activities
Costs of shipped inventory are transferred from inventory to cost of sales promptly and in the appropriate period.	Control activities
Only valid changes are made to the inventory management master file.	Control activities
All valid changes to the inventory management master file are input and processed.	Control activities
Changes to the inventory management master file are accurate.	Control activities
Changes to the inventory management master file are promptly processed.	Control activities
Inventory management master file data remain up-to-date.	Control activities

Figure 40—Application Control Objectives for the Asset Management Cycle	
Application Control Objective	**COSO Component**
Fixed asset acquisitions are accurately recorded.	Control activities
Fixed asset acquisitions are recorded in the appropriate period.	Control activities
All fixed asset acquisitions are recorded.	Control activities
Depreciation charges are accurately calculated and recorded.	Control activities
All depreciation charges are recorded in the appropriate period.	Control activities
All fixed asset disposals are recorded.	Control activities
Fixed asset disposals are accurately calculated and recorded.	Control activities
Fixed asset disposals are recorded in the appropriate period.	Control activities
Records of fixed asset maintenance activity are accurately maintained.	Control activities
Fixed asset maintenance activities records are updated in a timely manner.	Control activities
Only valid changes are made to the fixed asset register and/or master file.	Control activities
All valid changes to the fixed asset register and/or master file are input and processed.	Control activities
Changes to the fixed asset register and/or master file are accurate.	Control activities
Changes to the fixed asset register and/or master file are promptly processed.	Control activities
Fixed asset register and/or master file data remain up-to-date.	Control activities

Figure 41—Application Control Objectives for the Human Resources Cycle	
Application Control Objective	**COSO Component**
Additions to the payroll master files represent valid employees.	Control activities
All new employees are added to the payroll master files.	Control activities
Terminated employees are removed from the payroll master files.	Control activities
Employees are terminated only within statutory and union requirements.	Control activities
Deletions from the payroll master files represent valid terminations.	Control activities
Time and attendance data records reflect actual time worked and are authorized.	Control activities
All time worked is input.	Control activities
Time worked is accurately input and processed.	Control activities
Time worked is processed in a timely manner.	Control activities
Payroll is recorded in the appropriate period.	Control activities
Payroll (including compensation and withholdings) is accurately calculated and recorded.	Control activities
Payroll disbursements and recorded payroll expenses relate to actual time worked.	Control activities

Figure 41—Application Control Objectives for the Human Resources Cycle *(cont.)*

Application Control Objective	COSO Component
Payroll is disbursed to appropriate employees.	Control activities
Only valid changes are made to the payroll master files. All valid changes to the payroll master files are input and processed.	Control activities Control activities
Changes to the payroll master files are accurate.	Control activities
Changes to the payroll master files are processed in a timely manner.	Control activities
Payroll master file data remain up-to-date.	Control activities
Only valid changes are made to the payroll withholding tables.	Control activities
All valid changes to the payroll withholding tables are input and processed.	Control activities
Changes to the payroll withholding tables are accurate.	Control activities
Changes to the payroll withholding tables are promptly processed.	Control activities
Payroll withholding table data remain up-to-date.	Control activities
Statutory withholding tables are consistent with statutory requirements.	Control activities

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Public Company Accounting Oversight Board
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Re: PCAOB Rulemaking Docket Matter No. 008

Members and Staff of the Public Company Accounting Oversight Board:

I would like to thank you for the opportunity to comment on the Proposed Auditing Standard – *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. My response will address certain specific questions raised by the PCAOB, as well as some additional comments/observations regarding the text of the proposed standard.

The PCAOB asked the following question:

> **Q 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?**

I believe that this is a key question regarding the interpretation of the External Auditor's role in the SOX 404 certification process. As you know, section 404, paragraph (b) of the SOX Act states the following:

> (b) INTERNAL CONTROL EVALUATION AND REPORTING.—With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall **attest to, and report on, the assessment made by the management of the issuer**. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

The law requires the External Auditor to "***attest to***, and report on, the assessment made by the management of the issuer". The law does not explicitly state that the External Auditor must perform an "audit of internal controls over financial reporting". I understand that the External Auditors will still need to obtain sufficient evidence to satisfy the requirements of the "attestation engagement" (outlined in AT Section 101, paragraphs .51 - .58), however, I am of the opinion that the scope of this work might differ from that of a full scope "audit" of internal controls. In addition, I am of the opinion that the overall quality of management's assessment should have a significant impact on both the nature and extent of testing required by the External Auditors. I was encouraged by the following statement in the PCAOB *Briefing Paper* on the proposed auditing standard:

> Nevertheless, the work that management performs in connection with its assessment can have a significant effect on the nature, timing, and extent of the work the independent auditor will need to perform. The proposed auditing standard would allow the auditor to use, to a reasonable degree, the work performed by others, including management. **Thus, the more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be.**

I agree with this statement, but I do not believe that this concept has been adequately addressed in the text of the proposed standard. I would like to see some language addressing the direct relationship between the robustness/quality of management's assessment and the nature, timing and extent of the procedures required by the External Auditors. I am concerned that the External Auditors will not interpret the guidance in a manner consistent with the last sentence of the paragraph above. I would go as far as to say that it is not in their economic interest to interpret the guidance this way.

The strengthened role of the External Auditor, regarding the testing of internal controls, has created a situation where the External Auditor, with the support of the SOX Act, is in a much stronger position to determine the amount of "audit" work necessary to comply with SOX 404, paragraph (b). I believe that there are many ways to interpret the SOX Act, but many business people are concerned that the ultimate interpretation will be made by the External Audit firms. I see this as a potential conflict of interest and I am concerned that the External Audit profession is not equipped or structured to fulfill the role they have been entrusted with. I believe that if this situation is not resolved it could lead to serious conflict between business management and the External Audit profession and that would be counter productive to both the intentions and spirit of the SOX Act.

The PCAOB asked the following two questions:

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

The proposed standard allows the External Auditor to place <u>some</u> reliance on work performed by others, including management, internal auditors or third parties. To use that work, however, the auditor would need to assess the competence and objectivity of the persons who have performed it. I am pleased that the standard does allow some reliance to be placed on work performed by others and I also agree that the auditor would need to assess the competence and objectivity of the persons who have performed the work. However, I do feel that there is a need for much more guidance in this area otherwise this will be at the total discretion of the External Auditor.

Many organizations view their internal audit department as a specialized group of accounting/information systems professionals who are "internal control experts". Based on this, I believe that the internal audit function should play a significant role in many organization's efforts to comply with SOX 404. This role will take many forms including: documentation of existing controls, consultation and design of needed controls, testing of controls for effectiveness, etc. I believe that many of these roles are appropriate, however we are of the opinion that certain roles could impair the overall effectiveness and independence of the internal audit function. I would like the PCAOB to address the internal audit function in more detail in the standard and to include some specific guidance regarding when the function can be relied upon, to the greatest extent, by the External Auditors. It might be appropriate to incorporate some of the guidance in AU Section 322 – *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* into the standard (rather than just referencing it in Appendix B).

Paragraph 104 of the proposed standard prohibits the External Auditors from placing any reliance on the work done by others in areas related to company-wide anti fraud programs. I have some concerns regarding the effectiveness of the External Audit function when it comes to auditing for fraud. This problem was highlighted once again by the recent corporate scandals in the U.S. where the External Auditors were not successful in uncovering fraud, of a material nature, that existed at their clients (even when, in some instances, they were alerted to it by employees within the organization). Many of the External Audit procedures that I have observed in this area are based around inquiries of management and other key personnel. I believe that inquires serve a purpose, but they are certainly not the most effective way to uncover fraud in an organization. Many organizations have strengthened their corporate governance structures to address the issue of fraud prevention and detection. These new governance structures include some of the following components: fraud telephone "hotlines", employee code of conduct manuals, fraud training for employees, fraud investigation units, etc. I would like the PCAOB to consider that some of the strongest evidence that the External Auditors can obtain in this area will come from management's ongoing monitoring of their fraud prevention programs and from other independent functions within the organization (i.e. reports from fraud investigation units, internal audit, etc.). To limit the External Auditor's ability to rely on the results generated by outside parties is a mistake in my opinion. I do acknowledge that their reliance should be based on their assessment of the quality and objectivity of the function generating the evidence in question.

Paragraphs 104 and 79 of the proposed standard address the issue of the External Auditor's need to perform independent "walkthroughs" on all of the Company's significant processes. I am very concerned about the impact of this guidance, as this is an area where the internal audit function has traditionally been able to add considerable value, not just to the business process owners, but also to the External Auditors (in support of their financial audits). I see no reason why the External Auditors should not be allowed to place some reliance on walkthroughs generated by a qualified, objective, independent internal audit function. Under the current guidance, all of the existing work would need to be re-performed by the External Auditor and this would come at a significant cost to the business. In addition, I am of the opinion that a qualified and objective internal audit function is better positioned to produce a high quality walkthrough given their knowledge of the business operations. It has been my observation that this type of "walkthrough" work is typically assigned to the most junior auditors on an External Audit engagement team.

The internal and external audit functions at ING have always had a very strong working relationship. In our opinion, both groups play an important role in the overall assessment of internal controls within an organization and they should leverage off each other's work to the greatest extent possible. I believe that some of the recent corporate failures have highlighted the need for a strong, independent internal audit function in Corporate America, rather than increased reliance on the External Audit profession. Lets not forget that it was an internal auditor who exposed the accounting irregularities at WorldCom – not an External Auditor.

I would like to see the standard better define the way the two groups can work together to meet the testing requirements of SOX 404, paragraph (b) in the most rational and efficient manner possible.

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Düsseldorf, November 21, 2003

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

USA

By E-Mail: comments@pcaobus.org

Dear Sir(s):

Re: PCAOB Rulemaking Docket Matter No. 008
IDW Comments on the PCAOB Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

We would like to thank you for the opportunity to comment on the PCAOB Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements. The Institut der Wirtschaftsprüfer (IDW) represents approximately 85 % of the German Wirtschaftsprüfer (German Public Auditor) profession. The IDW seeks to comment on the proposals by the PCAOB noted above because we believe that this Proposed Rule will affect not only the development of auditing standards in the United States, but also influence auditing standards on internal control on a worldwide basis. Furthermore, a significant number of German Wirtschaftsprüfer are or will be subject to the requirements of the Sarbanes-Oxley Act.

General comments

Comment Period

We were disappointed to see the very short exposure period in which comments can be provided to the PCAOB. A comment period of 45 days is too short for a standard of such length and importance in an international environment, since many organizations would like to have the opportunity to consult with their stakeholders. We would suggest that 90 days might be more appropriate for longer proposed standards of greater complexity, such as this one.

We are convinced that, if we had had the opportunity to consult our stakeholders and analyze this standard with greater diligence, we would have found additional significant issues that might require your attention.

Comments on Particular Technical Matters

The Audit Opinions Required

Section 404 of the Sarbanes-Oxley Act (SOX) requires the annual report " …to contain an internal control report, which shall … contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting." Furthermore, …"each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer". Section 103 states that the Board "…shall include in the auditing standards that it adopts, requirements that each registered public accounting firm shall … describe in each audit report the scope of the auditor's testing of the internal control structure and procedures of the issuer required by Section 404 (b), *and* [italics added] present (in such report or in a separate report) (I) the findings of the auditor from such testing; (II) an evaluation of whether such internal control structures and procedures … ." Based on the wording in Section 103(2)(A)(iii), it appears to us that two opinions are being required of the auditor in relation to internal control: one on management's assessment and one on internal control directly.

We would like to point out that, contrary to the view expressed in footnote 3 of the proposed standard, an "audit of internal control over financial reporting" is not the same as "attestation of management's assessment of the effectiveness of internal control over financial reporting", nor does the former just refer to the process and the latter to the result of that process. We will provide our reasons for this assertion in the following paragraphs.

Presumably, management's assessment of the effectiveness of internal control would have to have the same scope (and cover the same period) as an audit of internal control performed by an independent third party so that management's assessment can be expressed at the level of reasonable assurance as described in paragraph 16 of the standard (this appears to be consistent with our reading of the requirements for management's assessment under the SEC's Release No. 33-8238 on Management's

Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports). This means that there is some residual risk that management's assessment had been appropriately performed but concludes that the internal control system is effective, even though it is not (the risk of incorrect acceptance). Hence, an independent auditor's attestation of management's assessment may conclude that management's assessment was appropriately performed, even though the internal control system is not effective.

This is different from the situation in which the independent auditor reaches an independent conclusion as to whether the internal control system is effective because, even thought the scope of the audit performed by the auditor may be the same as the assessment conducted by management, the auditor may, for example, choose different sample items on a random basis and thereby come to different conclusion than management.

In other words, we believe that SOX actually requires three separate opinions by the auditor: 1. on the fairness of the financial statements, 2. on the assessment of the effectiveness of internal control made by management and 3. on the effectiveness of the internal control. While these opinions may be closely related, they need not, by any means, lead to the same conclusion in all circumstances. For example, because internal controls only provide reasonable assurance that material misstatements will be prevented or detected on a timely basis, both management and the auditor may conclude that internal control is functioning effectively even though management or the auditor detect a material error in the financial statements by means other than the functioning of the internal control system. Likewise, in situations where the internal control system is not operating effectively and the audit of the internal control system by the auditor detects this, management may have appropriately conducted its assessment of the internal control system and concluded that the internal control system is operating effectively. Other combinations of opinions are conceivable. However, we suspect that some combinations will not be as relevant as others. For example, if management's assessment came to the conclusion that internal control is not effective, the auditor will examine the basis for that conclusion and it is very unlikely that he or she will reach a conclusion that is at variance with that of management in this case.

While the SEC's Release No. 33-8238 only addresses the auditor's opinion on management's assessment of the effectiveness of internal control, we believe that this does not preclude the PCAOB from requiring an opinion on internal control by the auditor beyond an opinion on management's assessment. The current draft standard is based on merging the opinion by the auditor on management's assessment of internal control with the opinion by the auditor on the effectiveness of internal control.

In our view, this approach is fundamentally flawed for the reasons given above. We therefore recommend that the standard be amended to provide for the auditor expressing three separate opinions, as noted in the previous paragraph. Furthermore, the standard should make clear that management's assessment should have the same scope (and cover the same time period) as an audit of internal control performed by an independent third party.

Reasonable Assurance

Paragraph 16 of the proposed standard states

> "Management's assessment of the effectiveness of internal control over financial reporting is expressed at the level of *reasonable assurance*. The concept of reasonable assurance is built into the definition of internal control over financial reporting and also is integral to the auditor's opinion. Reasonable assurance includes the understanding that there is a relatively low risk that material misstatements will not be prevented or detected on a timely basis. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance."

We are disappointed that the PCAOB is attempting to address a concept as fundamental, complex and important as the meaning of "reasonable assurance" as an "afterthought" within the confines of a proposed operational standard without having properly analyzed the issues surrounding the use of the term or exposed a separate issues or discussion paper to allow stakeholders adequate input before standards or rules dealing with fundamental auditing issues are proposed in this regard. We are particularly disappointed in this respect because we are aware that the AICPA had requested the PCAOB on more than one occasion in writing to commence a project on the meaning of "reasonable assurance".

With respect to the meaning of reasonable assurance, footnote 7 in the proposed standard refers to the "Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities and Exchange Commission Release No. 33-8238 (June 5, 2003)" for further discussion of reasonable assurance. Our review of this Rule indicates that the term "reasonable assurance" is addressed primarily in "II. Discussion of Amendments Implementing Section 404", "F. Periodic Disclosure about the Certifying Officer's Evaluation of the Company's Disclosure Controls and Procedures and Disclosure about Changes to its Internal Control over Financial Reporting", "4. Conclusions Regarding Effectiveness of Disclosure Controls and Procedures". In this Rule reasonable assurance is not defined: rather, footnotes 101 and 102 make reference to Sec-

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tion 13(b)(2) of the Exchange Act (15 U.S.C. 78m(b)(2)) and the Codification of Statement on Auditing Standards AU §319.18, respectively.

We believe that the reference to AU §319.18 is erroneous: the concept of reasonable assurance in relation to internal control is actually discussed in AU§ 319.21 to .24. In any case, the discussion of reasonable assurance in relation to internal control in AU §319 does not speak of “relatively low risk that material misstatements will not be prevented or detected”, nor suggest that reasonable assurance represents a “high level of assurance”. Rather this part of the AU §319 actually discusses the limitations of an entity’s internal controls and cost-benefit relationships, etc. We also note that the AICPA standard on performing attest engagements on internal control (AT §501) refers to neither reasonable assurance nor high assurance, but does discuss the inherent limitations of internal control.

Based on our reading, 15 U.S.C. 78m(b)(2) actually only refers to the provision of reasonable assurance by the internal control system without defining it. We note that 14 U.S.C. 78m(b)(7) defines reasonable assurance as “…the degree of assurance as would satisfy prudent officials in the conduct of their own affairs”. There is no mention of “relatively low risk” or “high assurance”.

We would like to point out that the issues surrounding the meaning of “reasonable assurance” are both politically and technically very complex and a treatise on the subject could fill volumes. In this respect we would like to refer to the discussion on the meaning of assurance and levels of assurance in the FEE Issues Paper “Principles of Assurance: Fundamental Theoretical Issues With Respect to Assurance in Assurance Engagements”. Nevertheless there is one issue that deserves mention to help focus on the practical problems involved.

Because audit or assessment risk is not separable from the uncertainties associated with the application of criteria to the subject matter, high inherent risks often cannot be alleviated through controls or an assessment or audit. This problem is often termed “consilience” by academics.

For example, a complex sales contract may be the basis for the determination of revenue recognition. Even after having obtained a legal opinion on the legal rights and obligations currently extant under the contract at year-end, both the preparer of the financial statements and the auditor may find that, in their view, the weight of evidence supporting recognition under applicable accounting standards is only slightly greater than that not supporting recognition: the situation is grey rather than black and white. Yet, both the preparer and auditor must reach a decision on the matter. In these circumstances, for example, neither can claim to have achieved a high level of assurance that, on balance, at least a slight majority of preparers and auditors would have agreed with their decision or that they had reduced the converse to a relative low level of risk (in measurement theory, this is known as the "equivalence" aspect of reliability).

Hence, relating reasonable assurance to high or to just below absolute assurance or to relatively low risk is fundamentally misleading because both preparers and auditors face many decisions that can only be made on the basis of what the legal profession terms "the preponderance of the evidence". This thought ties in to the concept that audit evidence is persuasive rather than conclusive or convincing.

The other main problem with the application of the reasonable assurance concept as currently suggested by the draft standard is the tendency for third parties to apply 20-20 hindsight to the concept of reasonableness. In other words, third parties (neither management nor the auditors) will tend to take the view that if a catastrophe occurs, then the controls that were designed and implemented to prevent that catastrophe could not have been reasonable or reasonably effective. This stance, which is in itself unreasonable, can only be countered by a technically and politically sound treatment of the meaning of reasonable assurance.

The definition of reasonable assurance also ties into the definition of a "significant deficiency", which we will address in the following section.

The definition of significant deficiency

Paragraph 8 defines significant deficiency as follows:

> "A *significant deficiency* is 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. A significant deficiency could be a single deficiency, or a combination of deficiencies, that results in a more than 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."

The use of the term "remote likelihood" is referred by footnote 5 to paragraph 3 of FASB Statement No. 5 Accounting for Contingencies (FAS No. 5), which defines the terms probable, reasonably probable and remote for events in relation to contingencies.

As we have pointed out in our discussion on reasonable assurance, the consilience between audit risk and the uncertainties associated with the application of criteria (accounting standards) to subject matter (events and circumstances) often reduces preparers and auditors to obtaining only a preponderance of the evidence to support decisions they have made with respect to the application of accounting principles in particular circumstances. In these circumstances, the application of controls, assessments or audits will not necessarily enable an increase in assurance nor a concomitant decrease in the risk that a material misstatement occurs. Consequently, we question whether it is appropriate to apply the standard of “more than a remote likelihood” that controls should be able to prevent or detect a material misstatement in all circumstances.

In this matter, it should be noted that the application of the probability concepts (probable, reasonably probable and remote) to evaluate events leading to loss contingencies is an entirely different matter than using these probability concepts in determining the likelihood (what level of assurance has been obtained) that the appropriate probability concept was chosen, which is what is being asked of the internal control system, and hence of management’s assessment and the auditors. Consequently, the application of the concept “remote” can only lead to situations where management or the auditors (or both) are blamed for situations beyond their control.

In this connection, we would like to point out that the term “remote” also has legal meaning that suggests its application for identifying significant deficiencies in internal controls is inappropriate (e.g., “remote possibility”, which refers to a limitation dependent upon two or more facts or events that are contingent and uncertain, or a double possibility). Another legal meaning relates possibilities to the burden of persuasion required in criminal courts of law: beyond any reasonable doubt, which is defined as “ … not a mere possible doubt; because every thing relating to human affairs, and depending upon moral evidence, is open to some possible or imaginary doubt” (Commonwealth v. Webster, 59 Mass. (5 Cush.) 295, 320 (1850)). On this basis a remote possibility represents a standard either higher than or equivalent to beyond any reasonable doubt, which, in turn, is a standard usually higher than that expected either of internal control, management assessments, or audits.

Consequently, we suggest that a significant deficiency be defined as “an internal control deficiency, that either singly or in combination with other deficiencies, adversely affects a company’s ability to initiate, record, process or report external financial data reliably in accordance with generally accepted accounting principles and thereby hinders management from obtaining reasonable assurance that a misstatement that is more than inconsequential in terms of the annual or interim financial statements will not be prevented or detected”.

Of course, such a change in the definition of a significant deficiency means that the definition of a material weakness ought to be amended accordingly.

Effectiveness

Both management's assessment and the auditor's opinion (on the assessment and on the internal control system) are in relation to the effectiveness of the internal control over financial reporting. While the concept of reasonable assurance that material misstatements will be prevented or detected on a timely basis is a useful standard, in practice, both management and auditors will require concrete effectiveness criteria. We would like to point out that it is a basic tenant of both assurance engagements (see ISA 100) and attest engagements (see AT §101) that criteria must be suitable before an assurance or attest engagement can be performed. In our view, the lack of suitable effectiveness criteria in this standard for internal control precludes the performance of a meaningful assessment by management and hence audit of effectiveness of internal control.

The Use of Work of Management and Others

While we agree, to the extent the auditor must form his or her own opinion, that tests performed by the auditor cannot be replaced by tests performed by management and others, we consider it to be dysfunctional to not allow the auditor to use information obtained from the work of management and others in designing and performing the auditor's work. For example, management may have detected a weakness in internal control. It would be dysfunctional for the auditor not to be in a position to apply a risk-based approach and use the information, obtained by management or others, that there may be greater risks in some areas, to the extent that the auditor has evidence to support the view that the work can be relied upon. In any case, because the auditor is expressing an opinion on management's assessment of internal control, the auditor is in a position to obtain evidence to support whether management's work in this regard is reliable.

IT-related controls

In our view, the proposed standard does not provide enough guidance with respect to IT-related controls. For example, in Example B1 of Appendix B (Daily Programmed Application control and Daily Information Technology-Dependent Manual Control), it is suggested that the auditor is in a position to conclude that computer controls operate in a systematic manner. In our view, the procedures performed by the auditor prior to the walk-through do not support such a conclusion. For example, in addition to the procedures mentioned, the auditor should have obtained some evidence to support conclusions with respect to relevant IT security controls (e.g., how does the system ensure that during the filing of information by the bank to the company others

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do not obtain information that they are not authorized to have, authorization checks to ensure that the bank rather than some other person or entity communicated that information, and other procedures to address privacy risks, etc.). Beside the risks arising in an e-business environment, in principle, computer aided commercial activities that are automatically interfaced with the entities accounting system affect assets or liabilities, results or expenses or income or lead to events requiring disclosures in the financial statements. Therefore, the reliability of accounting information depends on the reliability of the IT-aided transactions. The auditor has to assess the reliability and security of IT-aided transactions processing based on principles for appropriate accounting information processing (further guidelines with respect to this issue are provided by IFAC in; "E-Business and the Accountant: Risk Management to Accounting Systems in an E-publication Environment").

We hope you find our comments helpful and would be pleased to be of assistance to you if you have any questions about these comments.

Yours very truly,

Klaus Peter Naumann
Chief Executive Officer

Horst Kreisel
Technical Manager

495/532

21 November 2003

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street NW
Washington DC 20006-2083
USA

Dear Sirs

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

The Institute of Chartered Accountants in England & Wales is pleased to provide a letter of comment in response to the PCAOB's proposed standard entitled "An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements".

The Institute is the largest individual body of professionally qualified accountants in Europe with over 125,000 members. Individual members work in many sectors in business, the public sector as well as practising accountants and auditors. We operate under a Royal Charter that reflects our commitment to the public interest.

The proposed standard will have a significant impact on the work not only of US-based auditors and registrants, but also on the UK profession and those individuals throughout the world serving:

- foreign private issuers listed in the US; and
- foreign subsidiaries of US domestic SEC registrants which are bound by the same requirements as the US domestic entity as well as joint ventures with SEC registrant companies.

Consequently, we are sending a copy of this letter to the UK Auditing Practices Board and the International Auditing and Assurances Standards Board.

Introductory remarks

We are aware of the challenges faced by the PCAOB in preparing this exposure draft. Internal control is not a straightforward concept and the measurement of its effectiveness is not easy. Balancing the requirements of the Sarbanes-Oxley Act and the needs and views of investors, regulators, auditors and cost benefit considerations for businesses requires very careful consideration. Upon the Board's decisions on the future of the proposed standard appears to hang issues of expectations, the costs of implementation and future interpretation in the US courts. The pervasive impact of the proposed standard on global audit practice and, potentially, on the platforms used by global audit firms for their audit methodologies, imposes additional significant responsibilities on the PCAOB in finalising the proposed standard.

We are also aware of the debate in the US as to whether or not the Board's proposed standard extends the boundaries of Section 404(b) of the Sarbanes-Oxley Act from 'attestation' to 'audit'. Not all 'attestations' are 'audits'. Whatever the technical arguments for or against this proposed extension, it is a fundamental issue upon which there is a need for clarity from all those involved. We strongly urge the Board to be certain that the many outcomes that are likely to result from the proposed standard, including the costs and benefits to both investors and companies, as well as the liability to external auditors, the level of regulation, the consequent impact on external auditor judgement and the extensive additional work that is required for all SEC registrants, is what was intended by Congress when it passed the Sarbanes-Oxley Act and is also their current view (taking into account the other requirements and sanctions in the Act).

Finally, we hope that the PCAOB will give due consideration to the impact of its proposals on the IAASB's global audit standards and recognise the significance of those standards in discharging its responsibilities.

Key Comments

In addition to our introductory remarks, this letter contains key comments on adverse audit opinions, external auditor reliance on the work of management and others, reporting of control weaknesses and audit committee evaluations. Other general comments are also provided on significant issues. Our answers to the PCAOB's thirty one questions are included in the Appendix to this letter.

1 Adverse audit opinions and definitions

The proposed standard indicates that (under defined circumstances) a material weakness automatically gives rise to an adverse opinion. The proposed standard gives no apparent scope for an 'except for' opinion. Automatic adverse, rather than qualified, audit opinions leave external auditors with nothing left in their armoury as a last resort for situations in which things have gone very seriously wrong in many respects. An adverse opinion is almost universally understood by standard setters to mean that a pervasive, fundamental problem has arisen. Suggesting that such an opinion should be issued where this is not the case is likely to spread confusion.

The proposed definition of a material weakness in paragraph 9 states that a "…material weakness is a significant deficiency that…..results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be detected".

The phrase 'more than a remote likelihood' is derived from FAS 5 and is more tightly defined than the corresponding phrase in the existing AT 501 auditing standard, "does not reduce to a relatively low level". The use of the proposed phrase in connection with the definition of significant deficiencies is likely to result in very few material weaknesses being excluded. This will significantly affect the amount of work to be undertaken by both external auditors and management. We suggest that PCAOB considers whether the definition used in AT 501 is in fact preferable.

Overall, the proposed standard gives the impression of trying to achieve, and having an overall expectation of, ‘perfection’. This somewhat over-enthusiastic approach may not be cost-effective, particularly for smaller and medium sized companies. An appropriate balance of cost, benefit and regulation to improve investor protection is necessary but businesses should not be subjected to unnecessary, costly and stifling bureaucracy. We fear that the combined effect of these proposals would be to:

- inflate the scope of work that external auditors (and presumably, management) will be obliged to carry out;
- lead to scope changes to Section 404 readiness projects already underway at companies; and
- inflate the number of adverse opinions, thereby devaluing their impact which will not enhance investor confidence.

We therefore believe that a material weakness should *not automatically* result in an adverse opinion, and that external auditors should be allowed to use their professional judgement to determine whether a material weakness merits a qualified rather than an adverse opinion. Guidance might be provided on situations in which an adverse, rather than a qualified opinion would be appropriate. Such guidance might be aligned with the IAASB’s standards and guidance on auditors’ reports.

The specific requirements of section 404 (as interpreted by the SEC rules) relate to internal controls over financial reporting. The proposed standard sometimes refers to ‘internal control’ and sometimes to ‘internal control over financial reporting’. The latter is a much narrower term than the former. It is not always clear as to whether references to internal control in the text should be read as references to internal control over financial reporting. We suggest that the matter should be clarified at the beginning of the standard.

In example A-5 the auditor issues an unqualified opinion that refers to the report of the other auditors. We do not understand why a direct report on internal control effectiveness is given here rather than a report on management’s assessment, as with other unqualified opinions.

2 Reliance on internal audit and management testing

The proposed standard appears to restrict unnecessarily the use of judgement by external auditors when deciding whether, and to what extent, to rely on the work of others.

The wording in the proposed standard also appears contradictory. Wording in the introduction to the document seems encouraging about less work being required for companies that have good controls, but paragraphs in the main text of the proposed standard seem to negate this. For example, the second paragraph on page 8 of the introduction states that the work that management performs in connection with its assessment can have a “…significant effect on the nature, timing, and extent of the work the independent auditor will need to perform”. It goes on to state that the proposed auditing standard would allow the auditor to use, to a reasonable degree, the work performed by others, including management and that the more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be. Contrast this with paragraphs 104 and 105 of the proposed standard which detail areas where the external auditors should not, or are limited in their ability to, place reliance on the work of others. Paragraph 109 goes on to state that the external auditor must perform enough of the testing himself/herself such that that the external auditors’ own work forms the “principal evidence”.

Paragraphs 104 and 105 are unnecessarily restrictive. We believe that external auditors should be able use their judgement as to when they can rely upon the work of internal audit, provided that they are satisfied that the internal audit department's work is objective and performed by competent people who adhere to relevant professional standards.

We believe that the proposed standard builds in wasteful inefficiencies by insisting that the external auditor re-performs a substantial amount of testing. Management might reasonably ask (inhibited only by the fear of a qualified or adverse report) why internal audit or management should bother to perform tests if the external auditors are specifically required by the standard to do them again.

In practice, it is a possibility that CEOs will now ask for substantial help from their internal audit functions in complying with the requirements of the proposed standard; either by reviewing the processes and output of the testing on internal financial controls undertaken by management, or even by undertaking much of the detailed testing work on behalf of management. These scenarios, particularly the latter, may not be a welcome development where the remit of internal audit is directed to the provision of assurance to the audit committee and the board on the wider aspects of all an organisation's controls rather than just internal control over financial reporting.

Paragraph 108 of the proposed standard states that internal auditors "…would normally be expected to have greater competence with regard to internal control over financial reporting and objectivity than other company personnel". Whilst internal auditors would normally be expected to have greater *objectivity* than others in this and other areas, they may not have greater competence in financial reporting than financial reporting specialists.

3 Reporting of control weaknesses

We suggest that the requirement for the external auditor to communicate *all* deficiencies to the audit committee will lead to information overload for audit committees. It is likely that audit committees will receive the same or similar lists of issues from both internal and external auditors in the light of the fact that external auditors will have reviewed internal audit reports and must therefore re-communicate all the deficiencies already reported by internal auditors.

Paragraph 126 of the proposed standard states that a significant deficiency that remains uncorrected after some reasonable period of time is a strong indicator of a material weakness. This judgement as to what is 'reasonable' could be problematic, for example where the costs of a suggested control solution outweigh the benefits. Recognition should also be given to situations in which a company has several significant deficiencies but in completely unrelated areas. Does the aggregation principle apply in this case? If so, adverse audit opinions may become commonplace and will their significance be debased in the eyes of investors.

Furthermore, where errors are found, testing would usually be extended to determine whether this is a one-off insignificant error or evidence of a systematic breakdown in a control. Is the standard intended to be read such that one-off errors should be reported even when the auditor was prepared to stand by the judgement that they were not significant?

4 Audit committee evaluation

Paragraph 57 of the proposed standard requires the external auditors to form a view on the effectiveness of the audit committee.

These requirements introduce some circularity in that the audit committee which appoints, removes, approves the remuneration of, and evaluates the external auditor will itself be evaluated by the external auditor. This requirement may place the external auditor in conflict with the audit committee.

Whilst we believe that an assessment of the audit committee is appropriate because the audit committee is an important part of the internal control framework, there is no need for a separate stand-alone requirement. We believe that assessment of the audit committee by the external auditor will be effective provided that safeguards are implemented. These safeguards might involve a requirement for particular attention to be paid to the assessment by a partner or other senior person within the audit firm who is not directly involved with the audit (such as the independent review partner).

We disagree with paragraph 59 which requires that where the external audit evaluates the audit committee as being ineffective, this "…should be regarded as at least a significant deficiency and a strong indicator that a material weakness in internal control over financial reporting exists". A material weakness would automatically lead to an adverse audit opinion. We believe that the external auditor should be allowed to exercise professional judgement and consider other relevant factors, such as the role played by the board of directors. Furthermore, we also believe that reference to the use of judgement should also be made in paragraph 126 which describes other situations which should be regarded as at least a significant deficiency and a strong indicator that a material weakness exits.

In the UK, following the revised Combined Code on Corporate Governance issued in July 2003, from now on boards of directors will have to conduct a performance evaluation of the audit committee (Code provision A.6.1).

Other General Comments

5 Level of controls testing

Appendix B provides four examples of control testing procedures. All are low-level examples that relate to only one of the five COSO components, the 'control activities'. Whilst important, 'control activities' are not the principle areas of concern in cases of fraudulent manipulation of financial reporting.

It was frequently senior management's manipulation of earnings that was a major issue in recent scandals. Issues related to senior management and their ethics are part of the control environment and if examples are to be given at all, then some examples relating to the control environment would be particularly helpful. This is especially the case in the light of paragraph 104 which prohibits reliance by external auditors on the testing of internal audit or management.

The four examples illustrate that a very substantial amount of audit work is expected of external auditors at this basic level. The issuer is already required to carry out its own testing in this regard and those tests should yield the same results as external audit testing. We are not convinced that the requirement to test so much at this low level is necessary to protect investors.

Whilst we would expect basic low level controls to form an important element of the overall comfort obtained by CEOs and CFOs when making their certification, we would expect that they would represent a relatively low proportion. For example, high-level detective controls are typically a very significant element of overall comfort but they are not addressed in the examples.

6 Controls which do not naturally give rise to documentary evidence

Many companies are likely to have effectively designed controls, but it is not always easy to demonstrate or document their operational effectiveness.

For example, day to day supervision, coaching and reviewing of staff and their work in the accounting department are sound preventative controls but are ordinarily not documented on a continuing basis. Despite this, external auditors can often, by a process of enquiry and proper evidential corroboration, gain reasonable assurance that such controls exist and work effectively.

The proposed standard indirectly plays down the importance of such controls and may encourage companies to prepare documentation that would not otherwise be necessary from a business point of view.

We envisage that even routine meetings of management that act as a form of control, such as credit control meetings, will now have to be documented in detail to satisfy the perceived requirements of the standard. This will add additional cost and bureaucracy. The operation of some IT controls may also not be easy to document to the level that may be perceived as necessary under the proposed standard.

We question whether all this additional work on documentation will provide an increased level of protection for investors commensurate with the increased cost of compliance. We also question whether the proposals go further than the intentions of the Sarbanes-Oxley Act.

7 Reasonable assurance is not high assurance

Paragraph 16 states that reasonable assurance is a high level of assurance and that it includes the understanding that there is a relatively low risk that material misstatements will not be prevented or detected. This is a misleading over-simplification of current thinking on this subject that will encourage investors to take much greater comfort from the work performed by external auditors than is warranted.

It is generally accepted that reasonable assurance represents a range of different levels of assurance, depending in part on the qualities inherent in the subject matter. Paragraph 15 of ISA 200 *Objectives and general principles governing an audit of financial statements* issued by IAASB in November 2003 states that reasonable assurance is obtained when the auditor has reduced risk to an acceptably low level. We respectfully suggest that PCAOB aligns its description of reasonable assurance with current thinking in order to prevent false expectations, confusion and misunderstanding in an important area.

8 Need to reflect IT reality and service organisation auditor guidance

Major parts of many internal control systems are IT driven and have been developed either in-house, by a third party, or by a service provider. The guidance in the proposed standard often does not take this reality into account and instead provides guidance which is geared toward manual internal control systems. The proposed standard should acknowledge this reality and provide additional guidance reflecting it.

International and European guidance on the use by external auditors of service provider auditors is very limited and guidance for the service auditors themselves is non-existent. This will undoubtedly result in situations where external auditors will not be able to obtain sufficient comfort for their attestation on management's assessment because the use of the extensive US guidance on this issue cannot be forced on non US service providers and their auditors.

9 Management and auditor imbalances

The PCAOB should not lose sight of the fact that the proposed standard is a standard for external auditors, compliance with which cannot necessarily be forced upon the management of a company. The proposed standard introduces examples of new and specific requirements for companies that exceed those described in the relevant SEC rules on matters including the documentation and testing of controls by management.

Whilst the external auditor may qualify his report on internal controls or issue an adverse opinion if management fails to prepare documentation or test controls to the required standard, the external auditor effectively becomes an agent to prompt management action. Taking a worst case view, the external auditor could be held liable for failure to enforce the requirements of the proposed standards which relate to management, with no corresponding liability for management itself.

It may be appropriate for the SEC to consider the specific responsibilities of issuers in this regard.

10 Conflict over who finds adjustments

The proposed standard requires the auditor to issue an adverse opinion regarding the effectiveness of internal control over financial reporting in case of one or more material weaknesses.

Circumstances presumed to be at least a significant deficiency and a 'strong indicator' of a material weakness include identification by the external auditor of a material misstatement in the year-end financial statements that was not identified by the company's internal controls, even if management subsequently corrects the misstatement prior to issuance of the financial statements.

This change will have a profound effect on the relationship between an entity's management and its external auditors. It does not foster co-operation between management and the external auditor and will increase resistance to adjustments proposed by external auditors. Where the need for an adjustment is agreed there will be a strong incentive for management to claim that they 'found it first' or would have done if they had delayed providing information to auditors until they had completed their own checks. In extreme circumstances, it even may make it difficult for external auditors to perform their work because management may try to keep them out until the preparation of the financial statements is at an advanced stage, thus ensuring that the auditor is not the first to identify adjustments.

11 Assertions too prominent

Several references to financial statement assertions are too prominent and misconceived (penultimate paragraph page 4, paragraphs 66 to 70, Appendix A Example A-1 first paragraph). An audit of internal control over financial reporting should not be based on a 'bottom-up' approach starting with financial statement assertions, but should rather commence by determining the risks of material misstatement, followed by considering controls, and finally considering the financial statements of the entity. Financial statements are designed to report on the status and progress of the business of an entity and are not an end in themselves.

The prominence given to financial statement assertions in the proposed standard is not in line with IAASB standards and guidance on risk assertions. Large and medium size audit firms in Europe are committed to follow IAASB standards as of 2005. This inconsistency would have significant consequences for the move towards global standards. It would also have a profound effect on the audit methodologies to be developed by audit firms. These will become hugely complex and require considerable investment to redevelop software and retrain staff. Therefore, we urge the PCAOB to reconsider the prominence given to financial statement assertions in the proposed standard.

The guidance related to financial statement assertions in the paragraphs indicated above is also inconsistent with the guidance provided in the first paragraph on page 12 which commences with the design and operating effectiveness of controls.

12 Two audits

IAASB standards and guidance on risk require external auditors to identify significant risks to determine which internal controls should be audited further. This is not reflected in the Board's proposed standard which requires auditors to perform audit work on *all* internal controls, regardless of their risk profile.

The guidance in paragraphs 133 to 144 is meant to integrate the two audits (attestation on management's assessment and the audit of financial statements). The level of integration should be deepened such that the two audits serve the same purpose. The objective of an audit of internal controls over financial reporting should be to form a judgement on the control risks; this is part of the financial statement audit. The concepts of materiality and complexity should be introduced whereby internal controls should only be tested for material and complex control assertions, transactions, account balances and disclosures; substantive procedures may suffice for other transactions and balances. The proposed standard currently appears to require both tests of controls and substantive procedures for all assertions, accounts and disclosures.

13 The external auditor's responsibility with respect to fraud

The proposed standard is unclear as to the precise level of responsibility the external auditor assumes in connection with the prevention and detection of fraud.

The auditor is required in paragraph 24 to evaluate *all* controls specifically intended to address the risks of fraud that are reasonably likely to have a material effect on the company's financial statements, which presumably means controls falling under all five COSO components. Does this mean that external auditors are required to confirm that fraud controls are designed to prevent 'more than a remote likelihood of a financial reporting misstatement' arising from fraud and that these controls have operated effectively?

Collusion by more than one member of management to overcome existing controls and thereby perpetrate fraud is often more than a remote likelihood. But collusion is an inherent limitation in any control system and it is very difficult (and expensive) at best for management to implement controls to prevent it; careful consideration by management of the cost-effectiveness of a control must take place before implementation. Similarly, external auditors considering making control recommendations must also take account of cost-benefit considerations.

We fear that failure by external auditors to detect a control weakness in either design or operation which subsequently facilitates a fraudulent act at the issuer may, under the proposals, substantially alter the risk profile of the audit profession.

These requirements are potentially wide in scope and have substantial implications for the amount of work to be undertaken and the associated costs.

If you require any further information, please do contact me.

Yours faithfully

Robert Hodgkinson

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APPENDIX

Response to the questions in the PCAOB's Request for Comments

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?

No. Firstly, it is not appropriate because it is inconsistent with the practice of the IAASB which uses the term 'audit' to refer to the audit of financial statements only. The auditor's attestation of management's assessment is an assurance engagement leading to reasonable assurance and not an audit. Second, whilst we understand that the US accounting profession understands the word 'attestation' to cover audit, attest and other engagements, not all 'attestations' are audits. Is an audit of internal control what Congress intended when it used the words 'attestation and report' in section 404(b) of the Act?

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?

Qualified yes. Whilst we do not like restrictive prohibitions, we understand that legislation requires the two audits should be done together.

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?

In view of the answer to question 2, no.

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?

Qualified yes. Whilst we recognise that the PCAOB is sensitive to the needs of the many small and medium sized issuers, time will tell if the consideration was 'appropriate'. We are particularly concerned about the additional burdens on the small and medium sized registrants and hope that Appendix E will assist them and that its thinking will be incorporated into the proposed standard.

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.

No. Auditing standards should not specify levels of competence and training for audit specified procedures. These matters are already found in the national and international guidance on ethics.

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?

Qualified yes. We believe that the standard's proposed requirements for the performance of procedures to obtain evidence directly are at the same time excessive and unnecessarily restrictive, particularly insofar as auditors are not permitted to use their judgement in determining the extent to which they may use the results of testing by management and others (paragraphs 104 and 105).

We are not convinced that the requirement to obtain direct evidence of effectiveness in all areas of internal controls over financial reporting represents a reasonable use of resources from the point of view of investors, particularly in respect of the testing of control activities. The issuer is already required to carry out its own testing in this regard and those tests should yield the same results as external audit testing.

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

No. Although the suggestions included in paragraphs 43 to 47 on documentation might be helpful, the auditor should be allowed to apply professional judgement. We suggest that additional guidance is included on documentation requirements in line with the size of the entity.

Paragraph 43 refers indirectly to the COSO framework. Where a company is using a different framework for evaluation internal controls, the documentation may use different but equivalent components. Paragraph 43 should be amended to make this clear.

8. (a) Is it appropriate to state that inadequate documentation is an internal control deficiency, the severity of which the auditor should evaluate? (b) Or should inadequate documentation automatically rise to the level of significant deficiency or material weakness in internal control?

(a) Yes, as it allows for the use of professional judgement by the auditor.
(b) No.

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

Qualified yes. Walkthroughs are useful to document an understanding of processes and systems, but are not a comprehensive way of testing the effectiveness of controls. Materiality should be used by the external auditor in his judgement when deciding which systems and processes should be subject to walkthroughs.

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?

No. The external auditors using their professional judgement should be allowed to rely on walkthroughs performed by internal auditors and others after evaluating the objectivity and competence of the internal audit function. We refer to key comment 2 in our covering letter.

11. (a) 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 (b) every year or (c) may the auditor use some of the audit evidence obtained in previous years to support his or her current opinion on management's assessment?

(a) No.
(b) No.
(c) Yes.

The basic principle that external auditors should be able to use their prior knowledge and experience is applicable to every audit and should also be adopted for this type of engagement. Use of such knowledge is of course subject to the proviso that external auditors only rely on past experience after having satisfactorily updated their knowledge of the business in order to identify and focus on changes. This approach is reflected in IAASB's recently revised standards and guidance on risk assessment and internal controls

A requirement to obtain evidence on the effectiveness of controls for every control assertion, for every account balance and disclosure every year is impractical for the auditor and represents a disproportionate use of resources from the point of view of investors. External auditors who undertake high quality audit work should be permitted to use their professional judgement.

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

External auditors should never be required to *use* the work of management and others, but should be permitted to do so using their good professional judgement where appropriate. External auditors should only be able to *rely* on the work of others once they have satisfied themselves that it appropriate so to do.

The extent to which external auditors should be permitted to do so is further detailed in the response to question 13 below. We refer to key comment 2 in our covering letter.

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

No. We refer to key comment 2 in our covering letter.

We are sceptical about the practical application of such a rule-based approach to categorisation of controls, as described in paragraphs 104 and 105. We prefer a more principle-based approach whereby a range of controls from high level, management driven controls to low level routine controls is used to determine the acceptable level of reliance for the auditor. Control categorisation is not required because the important determining factors are the integrity and good faith of management, internal audit and others upon whom the external auditors may rely.

14. Does the proposed standard give appropriate recognition to the work of the internal auditors? If not, does the proposed standard place too much emphasis and preference on the work of internal auditors or not enough?

Qualified yes. The guidance provided in paragraph 108 is acceptable if the categorisation as described in question 13 is abolished and external auditors are be able to rely on internal audit work in the areas described in paragraph 104, when they consider it appropriate.

15. (a) Is the flexibility in determining the extent of reperformance of the work of others appropriate, or (b) 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)?

(a) Yes.
(b) No.

External auditors should use their professional judgement to determine whether it is appropriate to rely on the work of others.

We refer to key comment 2 in our covering letter.

16. Is the requirement for the auditor to obtain the principal 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?

No. External auditors should use their professional judgement to decide on which sources of evidence to rely, to determine whether it is appropriate to rely on the work of others, and to determine whether there is a need to obtain the principal evidence through their own work.

We refer to key comment 2 in our covering letter.

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?

No. We refer to key comment 1 in our covering letter for our views.

18. (a) Do the examples in Appendix D of how to apply these definitions in various scenarios provide helpful guidance? (b) Are there other specific examples that commenters could suggest that would provide further interpretive help?

(a) Yes.
(b) No.

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

Yes.

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?

Qualified no. We refer to key comment 3 in our covering letter, particularly in respect of reporting to the audit committee.

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

Qualified yes. The issues identified are appropriate but external auditors should be permitted to use their judgement in this area.

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?

Qualified yes. The assessment should not be a separate requirement. We refer to key comment 4 in our covering letter.

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

Qualified yes. We refer to key comment 4 in our covering letter.

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. We consider that requiring an auditor to resign is not something that should be encouraged in anything other than extreme circumstances. Such a general requirement is unlikely to help investor confidence. External auditors should be allowed to use their professional judgement, depending on the circumstances of the situation.

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?

No. We refer to key comment 1 in our covering letter.

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

Yes. We refer to key comment 1 in our covering letter.

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 internal control over financial reporting rather than to whether management's assessment is fairly stated?

No.

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

No. Other existing standards address such issues at length. We refer to our response to question 29.

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

Yes. Although we favour principle-based standards which rarely include prohibitions, we believe that it is appropriate to limit the performance of certain internal control-related non-audit services by the financial statement auditor. No additional guidance is required in this respect as the SEC independence rules deal with this topic in sufficient detail.

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. However we note that section 302 of the Sarbanes-Oxley Act and the related SEC rules do not require quarterly reporting for foreign registrants.

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

See answer to question 30.

The Institute of Internal Auditors

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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 No. 008

Dear Sir/Madam:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Best regards,

William G. Bishop III

Attachment

A - Detailed Comments on the Proposal

B - Reconciliation of PCAOB Questions to IIA Response

Enclosures

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

THE INSTITUTE OF INTERNAL AUDITORS (IIA)
Attachment A
Detailed Comments on the Proposed Standard - November 21, 2003

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

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

IIA Issue #1 – Reliance on Internal Audit Efforts

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

Question 14 - Does the proposed standard give appropriate recognition to the work of internal auditors? If not, does the proposed standard place too much emphasis and preference on the work of internal auditors or not enough?

<u>Issues</u>

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

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

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

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

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

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

Recommendations

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

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

IIA Issue #2 – Walkthroughs

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

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

Question 10 - Is it appropriate to require that the walkthrough be performed by the auditor himself or herself, rather than allowing the auditor to use walkthrough procedures performed by management, internal auditors, or others?

Issues

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

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

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

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

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

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

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

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

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

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

Recommendations

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

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

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

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

IIA Issue #3 – Reliance on the Work of Others

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

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

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

Question 15 - Is the flexibility in determining the extent of reperformance of the work of others appropriate, or should the auditor be specifically required to reperform a certain level of work (e.g. reperform tests of all significant accounts or reperform every test performed by others that the auditor intents to use)?

<u>Issues</u>

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

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

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

<u>Recommendations</u>

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

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

   - The competence and objectivity of those performing the work.

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

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

IIA Issue #4 - Principal Evidence Requirements for Auditors

Relevant Sections of the PCAOB Proposed Standard:
Paragraphs 103-109

Question 6 - Is the scope of the audit appropriate in that it requires the auditor to both evaluate management's assessment and obtain, directly, evidence about whether internal control over financial reporting is effective?

Issues

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

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

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

Recommendations

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

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

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

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

Relevant Sections of the PCAOB Proposed Standard:
Paragraph 18

Issues

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

We reach this conclusion based on the following points:

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

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

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

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

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

Recommendation

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

IIA Issue #6 - Audit Assurance Levels

Relevant Sections of the PCAOB Proposed Standard:
Question 6 – Is the scope of the audit appropriate in that it requires the auditor to both evaluate management's assessment and obtain directly, evidence about whether internal control over financial reporting is effective?

Issues

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

Supporting this position are the following points.

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

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

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

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

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

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

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

Recommendations

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

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

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

IIA Issue # 7 – Evaluating Audit Committee Governance

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

Question 22 - Is it appropriate to require the auditors to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting?

Issues

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

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

Issues

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

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

Recommendations

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

IIA Issue # 8 – Review of Information Technology Controls

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

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

Issues

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

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

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

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

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

Recommendations

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

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

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

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

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

IIA Issue # 9 – Fraud Requirements

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

Issues

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

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

Recommendations

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

IIA Issue # 10 – Definition of Significant Deficiencies

Relevant Sections of the PCAOB Proposed Standard:
Question 17 - Will the definitions in the proposed standard of significant deficiency and material weakness provide for increased consistency in the evaluation of deficiencies? How can the definitions be improved?

Question 18 - Do the examples in Appendix D of how to apply these definitions in various scenarios provide helpful guidance? Are there other specific examples that commenters could suggest that would provide further interpretive help?

Issues

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

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

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

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

Recommendations

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

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

IIA Issue # 11 – Rotation of Audit Work

Relevant Sections of the PCAOB Proposed Standard:
Paragraph 101

Question 11 - Is it appropriate to require the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year, or may the auditor use some of the audit evidence obtained in previous years to support his or her current opinion on management's assertion?

Issues

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

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

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

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

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

Recommendations

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

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

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

Question	Relevant Reference in IIA Response
1. Is it appropriate to refer to the auditor's attestation of management's assessment of the effectiveness of internal control over financial reporting as the audit of internal control over financial reporting?	Issues #5, #6
2. Should the auditor be prohibited from performing an audit of internal control over financial reporting without also performing an audit of the financial statements?	Issues #5, #6
3. Rather than requiring the auditor to also complete an audit of the financial statements, would an appropriate alternative be to require the auditor to perform the work with regard to the financial statements comparable to that required to complete the financial statement audit?	--
4. Does the Board's proposed standard give appropriate consideration to how internal control is implemented in, and how the audit of internal control over financial reporting should be conducted at, small and medium sized firms?	--
5. Should the Board, generally or in this proposed standards, specify the level of competence and training of the audit personnel that is necessary to perform specified auditing procedures effectively?	--
6. Is the scope of the audit appropriate in that it requires the auditor to both evaluate management's assessment and obtain, directly, evidence about whether internal control over financial reporting is effective?	Issues #4, #6
7. Is it appropriate that the Board has provided criteria that auditors should use to evaluate the adequacy of management's documentation?	--
8. Is it appropriate to state that inadequate documentation is an internal control deficiency, the severity of which the auditor should evaluate? Or should inadequate documentation automatically rise to the level of significant deficiency or material weakness in internal control?	--
9. Are the objectives to be achieved by performing walkthrough sufficient to require the performance of walkthroughs?	Issue #2
10. Is it appropriate to require that the walkthrough be performed by the auditor himself or herself, rather than allowing the auditor to use walkthrough procedures performed by management, internal auditors, or others?	Issues #1, #2, #3
11. Is it appropriate to require the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year or may the auditor use some of the audit evidence obtained in previous years to support his or her current opinion on management's assessment?	Issue #11
12. To what extent should the auditor be permitted or required to use the work of management and others?	Issues #1, #3, #9
13. Are the three categories of controls and the extent to which the auditor may rely on the work of others appropriately defined?	Issues #3, #8, #9

Question	Relevant Reference in IIA Response
14. Does the proposed standard give appropriate recognition to the work of internal auditors? If not, does the proposed standard place too much emphasis and preference on the work of internal auditors or not enough?	Issue #1
15. Is the flexibility in determining the extent of reperformance of the work of others appropriate, or should the auditor be specifically required to reperform a certain level of work (e.g. reperform tests of all significant accounts or reperform every test performed by others that the auditor intents to use)?	Issue #3, #8, #9
16. Is the requirement for the auditor to obtain the principle evidence, on an overall basis, through his or her own work the appropriate benchmark for the amount of work that is required to be performed by the auditor?	Issue #4
17. Will the definitions in the proposed standard of significant deficiency and material weakness provide for increased consistency in the evaluation of deficiencies? How can the definitions be improved?	Issue #10
18. Do the examples in Appendix D of how to apply these definitions in various scenarios provide helpful guidance? Are there other specific examples that commenters could suggest that would provide further interpretive help?	Issue #10
19. Is it necessary for the auditor to evaluate the severity of all identified internal control deficiencies?	--
20. Is it appropriate to require the auditor to communicate all internal control deficiencies (not just material weaknesses and significant deficiencies) to management in writing?	--
21. Are the matters that the Board has classified as strong indicators that a material weakness in internal control exists appropriately classified as such?	Issues #7, #10
22. Is it appropriate to require the auditors to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting?	Issue #7
23. Will auditors be able to effectively carry out their responsibility to evaluate the effectiveness of the audit committee's oversight?	Issue #7
24. If the auditor concludes that ineffective audit committee oversight is a material weakness, rather than require the auditor to issue an adverse opinion with regard to the effectiveness of the internal control over financial reporting, should the standard require the auditor to withdraw from the engagement?	Issue #7
25. Is it appropriate that the existence of a material weakness would require the auditor to express an adverse conclusion about the effectiveness of the company's internal control over financial reporting, consistent with the required reporting model for management?	--
26. Are there circumstances where a qualified "except for" conclusion would be appropriate?	--
27. Do you agree with the position that when the auditor issues a non-standard opinion, such as an adverse opinion, that the auditor's opinion should speak directly to the effectiveness of the internal control over financial reporting rather than to whether management's assessment is fairly stated?	Issue #6

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

INTEL CORPORATION
5350 N.E. Elam Young Parkway
Hillsboro, OR 97124

November 19, 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

Ladies and Gentlemen:

Thank you for the opportunity to comment on the Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of the Financial Statements* (the "Proposed Standard"). This Proposed Standard concerns attestation engagements pursuant to Sections 103(a)(2)(A)(iii) and 404(b) of the Sarbanes-Oxley Act of 2002 (the "Act"). On behalf of Intel Corporation, we offer the following comments with regard to the Proposed Standard.

EXECUTIVE SUMMARY

General Comment.

We believe it is important to retain focus on the Act's original objective of reinforcing "the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting."[1] Unfortunately, the prescriptive nature of the Proposed Standard could undermine the Act's objective by seemingly placing much of the burden of providing reasonable assurance on the shoulders of external auditors. Instead, we recommend the Proposed Standard be modified to reinforce management's role in assessing internal controls over financial reporting.

Reliance on the work of others.

We applaud the Public Company Accounting Oversight Board's ("PCAOB") sensitivity to cost-benefit considerations in its statement: "[t]he more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be."[2] However, we believe the totality of the Proposed Standard unnecessarily restricts the auditor's ability to rely on competent management and internal audit work. Specifically, the Proposed Standard states: "the auditor's own work must provide the principal evidence for the audit opinion."[3] The Proposed Standard then proceeds to bar the use of management and internal audit testing in the broad areas of: (1) "controls that are part of the control environment"; (2) "controls over the

[1] Sarbanes-Oxley Act of 2002 §404(a)(1), Pub. L. No. 107-204, 116 Stat. 745.
[2] PCAOB Release No. 2003-017, Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* 8 (Oct. 7, 2003).
[3] *Id.* at 14.

period-end financial reporting process"; and (3) "controls that have a pervasive effect on the financial statements, such as certain information technology general controls . . . ."[4] Finally, the Proposed Standard limits the use of management and internal audit testing of "controls over significant nonroutine and nonsystematic transactions."[5]

The Proposed Standard should allow both internal and external audit to modulate the scope of required testing consistent with the quality of management's work as determined in the auditor's judgment. If management's work is sufficiently planned and executed, then duplicative testing imposes substantial costs on companies with questionable benefit for investors. Additionally, as discussed further below, while we do not support the PCAOB's proposal to characterize the internal control attestation as an audit, the concept of integrating the financial statement audit and internal controls attestation should be reinforced throughout the Proposed Standard. We expect there will be ample opportunity to leverage the financial statement audit to satisfy internal controls validation requirements.

Moreover, the Proposed Standard should allow broad reliance on internal audit's work where external audit determines internal audit is competent, objective, and sufficiently independent. As drafted, the Proposed Standard is even more restrictive than the current model used for financial statement audits under Statement on Auditing Standards No. 65.[6] For example, when conducting the financial statement audit, external audit routinely relies on internal audit to test IT general controls. The Proposed Standard should carry such reliance forward to the attestation work.

Introduction of new and broad terminology.

While we appreciate the PCAOB's efforts to clarify the definition of "significant deficiency," which is not currently well defined in the auditing literature, we believe the PCAOB's proposed definitions of both "significant deficiency" and "material weakness" capture an unnecessarily low and insignificant level of control deficiencies which were not within the intent of Congress when the Act was adopted, and also introduce significant ambiguities which will make it difficult for companies or external auditors to interpret and apply the definitions. This lowering of the reporting threshold, with its effect of inundating management and the audit committee with an overwhelming volume of low-level deficiencies, could unintentionally dilute management and audit committee focus on those deficiencies truly warranting their attention. Furthermore, we are concerned by language that indicates an accumulation of significant deficiencies, in and of itself, could lead to a material weakness. If the significant deficiency threshold is lowered and significant deficiencies are then accumulated to lead to a material weakness conclusion, the unintended result may be investor confusion, not insight, on the actual severity of internal controls deficiencies.

As an alternative to the PCAOB's approach, we recommend the Proposed Standard give companies and the external auditors latitude to exercise judgment in determining those deficiencies that are significant enough to be elevated to management and the audit committee, or disclosed in public filings, while using more well-established terminology to provide

[4] *Id.* at A-38.
[5] *Id.*
[6] *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU § 322).

definitional guidance. Rather than introducing the term "inconsequential" in the significant deficiency definition, we recommend that the PCAOB use the well-understood concept of materiality in addressing the magnitude of both a significant deficiency and a material weakness, and use different degrees of likelihood to distinguish between the two. Specifically, we recommend that the definitions hinge on whether there is a reasonable possibility individual or aggregated deficiencies would lead to a material adjustment in the financial statements, in the case of significant deficiencies, and on whether it is reasonably likely the deficiencies would lead to a material adjustment in the financial statements, in the case of material weaknesses. Using terminology that is already well-interpreted in the auditing literature, Securities and Exchange Commission ("SEC") guidance and judicial decisions will give companies and auditors greater ability to apply the definitions in exercising their judgment.

In addition, we request the PCAOB avoid using terminology that appears to extend beyond the financial reporting controls scope of the SEC's rules. For instance, ineffective internal audit, risk assessment, and regulatory compliance functions are listed as examples of significant deficiencies.[7] Yet in many companies, these functions extend beyond the realm of internal controls over financial reporting.

Role of the audit committee.

We recognize and fully support the audit committee's critical role in corporate governance. The audit committee should ensure proper tone at the top and act as an escalation point, but because it is difficult for the committee to truly understand the detailed operation of the company, it should not be expected to engage in the lower levels of internal control. The audit committee should not be inundated with reports of mundane and immaterial deficiencies. Thus, the Proposed Standard should not require the auditor to report *all* deficiencies to the audit committee, but should instead require the auditor to exercise judgment to determine which issues are sufficiently significant to warrant audit committee notification. In exercising this professional judgment, the auditor should evaluate whether there are effective measures and escalation channels in place to provide appropriate management and audit committee visibility to significant deficiencies and material weaknesses. In summary, we believe the Proposed Standard should focus on proper reporting processes and escalation procedures as opposed to requiring the escalation of all deficiencies.

Furthermore, under Section 301 of the Act, "[t]he audit committee . . . shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer . . . ."[8] Therefore, there is an inherent conflict of interest with the external auditor evaluating the effectiveness of the audit committee.

Consistency with the COSO Framework.

The Proposed Standard aptly recognizes many of the inherent limitations of internal control over financial reporting; however, the Proposed Standard fails to include the critical cost-benefit limitation called out in the COSO Framework. The COSO Framework states: "Another limiting factor is that the design of an internal control system must reflect the fact that there are resource

[7] *Id.* at A-43.
[8] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

constraints, and the benefits of controls must be considered relative to their costs."[9] We request this, or similar, language be added to the inherent limitations section of the Proposed Standard.

In closing, we would like to reinforce that Intel fully supports management accountability for maintaining effective internal controls over financial reporting. The Proposed Standard should build on that ownership model and allow greater reliance on the thorough and competent work of both management and internal audit. Otherwise, costs are likely to escalate well beyond any benefits to be achieved.

We thank you for consideration of our views. We have also attached our responses to the PCAOB's 31 questions in Exhibit A. Please contact Jim Campbell at (503) 696-7931 if you would like any further information in connection with our comments.

Regards,

Jim Campbell
Corporate Controller
Intel Corporation

[9] Committee of Sponsoring Organizations of the Treadway Commission ("COSO"), *Internal Control-Integrated Framework* 6 (1994).

EXHIBIT A
RESPONSES TO PCAOB QUESTIONS

Questions regarding an integrated audit of the financial statements and internal control over financial reporting:

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?

No. Pursuant to Section 404(b) of the Act, "each registered public accounting firm . . . shall attest to, and report on, the assessment made by the management of the issuer."[10] In doing so, the auditor is expressing a conclusion about the reliability of management's written assertion. To conclude on management's assertion, the auditor will need to perform sufficient attest procedures to reduce to a low level the probability of not discovering materially misstated assertions. But the level of testing would not be as extensive as that required in an "audit" of internal control over financial reporting, where it would be necessary for the auditor to opine on the effectiveness of the design and operation of controls.

We are concerned that the PCAOB's use of the term audit in place of attestation conveys an inordinate emphasis on independent testing. While we acknowledge the benefits of selective independent testing to validate management's assessment, non-value-added, duplicative testing needlessly increases costs to companies and investors. Additionally, calling this the audit of internal control over financial reporting makes it appear this is a stand-alone audit. Instead, we recommend the PCAOB select language that reinforces the concept of integrating the financial statement audit and internal controls attestation.

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 an absolute bar on separate engagements is theoretically unnecessary, in practice, separate engagements would be costly and inefficient. We therefore expect to use the same auditing firm for both the internal control attestation and the financial statements audit.

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?

Some companies may feel it is important to have this flexibility. This would not be a cost-effective approach for us, and we therefore have no issue with requiring that the same auditing firm conduct both engagements.

[10] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

Question regarding the costs and benefits of internal control:

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?

As this question does not pertain to Intel, we have no comment on this matter. However, it should be noted that COSO's study of fraudulent financial reporting found:

> Relative to public registrants, companies committing financial statement fraud were relatively small. The typical size of the sample companies ranged well below $100 million in total assets in the year preceding the fraud period. Most companies (78 percent of the sample) were not listed on the New York or American Stock Exchanges.[11]

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.

No. The PCAOB should leave it to the audit firm to determine the professional competencies and training necessary to execute the attestation in accordance with the Proposed Standard's framework. The PCAOB, however, should encourage audit firms to include COSO and other internal controls training in their curriculums. Additionally, it is important for the auditors to have the business context for the particular engagement in order to perform an internal controls evaluation effectively.

Questions regarding evaluation of management's assessment:

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?

While the auditor should leverage competent management work and the integrated financial statement audit to minimize redundant testing, we do support selective independent testing. This cost-sensitive approach will allow the auditor to satisfy his or her obligation to validate management's assessment and will encourage management to develop quality documentation and test procedures.

[11] COSO, *Fraudulent Financial Reporting: 1987-1997 - An Analysis of U.S. Public Companies, available at* http://www.coso.org.

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

We also support the flexibility to tailor the form of the documentation to the individual company circumstances and to allow auditor judgment in evaluating the adequacy of the documentation.

8. Is it appropriate to state that inadequate documentation is an internal control deficiency, the severity of which the auditor should evaluate? Or should inadequate documentation automatically rise to the level of significant deficiency or material weakness in internal control?

The auditor should evaluate the impact of inadequate documentation on internal control. As documentation is only one indication of good internal control, inadequate documentation should not automatically rise to the level of a significant deficiency, material weakness, or for that matter, a deficiency. Per the COSO Framework: "Many controls are informal and undocumented, yet are regularly performed and highly effective. . . . The fact that controls are not documented does not mean that an internal control system is not effective, or that it cannot be evaluated."[12]

<u>Questions regarding obtaining an understanding of internal control over financial reporting:</u>

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

First, we believe the Proposed Standard should give the auditor latitude to determine the appropriate scope of walkthroughs. Additionally, the Proposed Standard should reinforce the concept of integration. Wherever possible, walkthroughs should be conducted in a manner that simultaneously achieves the objectives of both the financial statement audit and internal controls attestation. Furthermore, as discussed in our answer to Question 10, the auditor need not personally conduct *all* walkthroughs but should instead be able to rely on walkthroughs performed by management and internal audit. Finally, certain processes do not lend themselves to walkthroughs so auditor judgment would be required to determine the appropriate test procedures.

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?

No, it would not be appropriate to require the auditor to personally conduct *all* walkthroughs. We believe the auditor should have the flexibility to vary the number and scope of the required walkthroughs based on the quality and completeness of management's documentation and internal audit's test procedures. In addition, the walkthrough strategy should capitalize on the integration of the financial statement audit and internal controls attestation.

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[12] COSO, *Internal Control-Integrated Framework* 73 (1994).

<u>**Question regarding testing operating effectiveness:**</u>

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?

While it is reasonable for the auditor to obtain annual *evidence* of the effectiveness of controls for significant accounts, the Proposed Standard should not require the auditor to obtain *direct evidence* on *all* accounts every year. Instead, the auditor should have the flexibility to rely on management's work and the ability to leverage accumulated learning from prior years. A more restrictive approach would increase costs with questionable benefit for investors.

In addition, the test plan should carefully consider the quality of management's assessment to determine the scope of testing required. Similarly, based on the independence and proficiency of the internal audit function, greater reliance could be placed on internal audit's testing.

<u>**Questions regarding using the work of management and others:**</u>

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

The Proposed Standard should allow both internal and external audit to modulate the scope of the required testing based on the quality of management's assessment. Moreover, the Proposed Standard should allow greater reliance on independent, competent testing by internal audit. If management's work and internal audit's testing are sufficiently planned and executed, duplicative efforts needlessly increase costs to companies and investors.

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

The categories are overly restrictive. To avoid non-value-added rework, the Proposed Standard should reinforce integration of the financial statement audit and internal controls attestation and should allow the auditor to flex the reliance level based on the competence and completeness of management's and internal audit's work.

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?

No. As stated in our cover letter, the independent testing guidelines unduly restrict the use of internal audit's work. The Proposed Standard should allow broad reliance on internal audit's work where external audit determines internal audit is competent, objective, and sufficiently independent.

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)?

Additional restrictions are not necessary. The auditor should be able to use his or her professional judgment to determine the extent of reperformance.

16. Is the requirement for the auditor to obtain the principal 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?

No. First, we would ask for a more robust definition of what would constitute principal evidence. This definition should recognize that principal evidence is composed of both quantitative and qualitative elements. Additionally, we note that an inflexible principal evidence benchmark would fail to recognize fact-specific circumstances. The auditor should utilize his or her professional judgment to vary reliance consistent with the quality of management's work and internal audit's testing. Where management has performed a quality assessment and internal audit has performed competent testing, the auditor should have the flexibility to rely more heavily on their work.

Questions regarding evaluating results:

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?

As stated in our cover letter, we recommend the Proposed Standard give companies and external auditors latitude to exercise judgment in determining those deficiencies that are significant enough to be elevated to management and the audit committee, or disclosed in SEC filings. It is important though, to promote consistency in exercising this judgment, that the rules provide adequate definitional guidance using terminology that is already well-interpreted in the auditing literature, SEC rules and interpretations, and judicial decisions. We believe that Congress intended the Act's reporting and disclosure requirements related to significant deficiencies and material weaknesses to apply to serious control issues that run real risks of causing significant financial reporting issues, and the definitions set forth in the Proposed Standard instead reach immaterial and insignificant control issues. Consequently, if these definitions are adopted, we believe audit committees and investors will be inundated with irrelevant information, increasing the risks that audit committees will fail to fully appreciate and follow up on the truly serious issues and investors will simply be confused. We do not believe the "more than remote" and "more than inconsequential" terminology used in these definitions will promote increased consistency, because we believe that the lines between "slight" and "more than slight", and between "inconsequential" and "more than inconsequential" are very difficult to draw and even reasonable issuers acting with the best of intentions will inevitably interpret those terms differently in similar fact situations.

As an initial matter, by introducing the term "more than inconsequential" in the description of a significant deficiency, the PCAOB has created unnecessary ambiguity. It is not at all clear what this term means, or where the line is between something that is completely inconsequential and something that is slightly less, or in the PCAOB's terminology, "more than" inconsequential. Both definitions should hinge on whether the deficiencies at issue could lead to a material adjustment in the financial statements, and the distinction between a significant deficiency and a material weakness should be determined by reference to the degree of likelihood that a material financial reporting issue will result.

The use of "more than remote" as the degree of likelihood in the significant deficiency and material weakness definitions establishes an unnecessarily low bar for control deficiencies that would require reporting to the audit committee or a conclusion that the company's controls are ineffective.[13] We believe the PCAOB's definitions are inconsistent with the definitions of material weakness and reportable condition (from which the term "significant deficiency" appears to have been derived) that existed in the audit literature at the time the Act was passed and therefore must be afforded due consideration in determining Congressional intent. The definition of material weakness is 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."[14] Reportable conditions are "matters coming to the auditor's attention that, in his (or her) judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of the internal control, which **could** adversely effect the organization's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements."[15] The auditing literature already contains substantial guidance on the factors that should be considered in determining whether there is a reportable condition or a material weakness and we do not believe the PCAOB should supplant that guidance in these rules.

We believe it would be more appropriate for the PCAOB rules to use the existing terms "reasonably possible" and "reasonably likely" in these definitions. The FAS 5 definition of "reasonably possible" is more than remote but less than likely, and the SEC's definition of "reasonably likely" is more than merely possible but not necessarily more likely than not.[16] By using a range, these definitions provide better guidance for the exercise of judgment when evaluating the seriousness of control deficiencies.

[13] We have the same concern with the "more than remote" threshold as used in other parts of the Proposed Standard, such as paragraph 61addressing the definition of a significant account. We strongly urge the PCAOB to address the difficulties of determining when the chances of an event occurring are more than slight, and to revise these references throughout the Proposed Standard to, at minimum, a "reasonably possible" standard.
[14] Statement on Auditing Standards No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU § 325) (emphasis added).
[15] *Id.* (emphasis added).
[16] See SEC Release No. 33-8182; 34-47264 - Disclosure in Management's Discussion and Analysis ("MD&A") about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, note 99 and related text; SEC Release Nos. 33-8185; 34-47276 - Implementation of Standards of Professional Conduct for Attorneys, note 50 and related text.

We note that in SEC Release No. 33-8182; 34-47264 - Disclosure in Management's Discussion and Analysis ("MD&A") about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, the SEC decided to adopt a "reasonably likely" standard for disclosure of off-balance sheet arrangements in MD&A, after first considering an earlier proposed "higher than remote" standard. The "higher than remote" standard was initially proposed by the SEC because Section 401(a) of the Act refers to disclosure of off-balance sheet arrangements that "may" have a material future effect on the registrant. In its commentary on why it chose to adopt the "reasonably likely" threshold, the SEC noted that this standard reached the information most relevant to investors, noted the difficulties issuer would have in applying the "higher than remote" threshold, and concluded: "We believe that the 'reasonably likely' threshold best promotes the utility of the disclosure requirements by reducing the possibility that investors will be overwhelmed by voluminous disclosure of insignificant and possibly unnecessarily speculative information." We note the use of the word "could" in the reportable condition definition and Section 401(a)'s use of the word "may," and the SEC's adoption of a "reasonably likely" threshold in the Section 401(a) context.

In light of the SEC's interpretation of Section 401(a), it is possible to conclude that the term "could" in the reportable condition definition translates into a "reasonably likely" threshold for significant deficiencies, and the threshold for material weaknesses should be even higher, such as a "more likely than not" or "probable" standard. However, we believe that the term "does not reduce to a relatively low level" from the existing material weakness definition is inconsistent with the use of a threshold higher than reasonable likelihood. Therefore, we think thresholds of "reasonable likelihood" for material weaknesses, and "reasonable possibility" for significant deficiencies are the most consistent with existing literature and interpretations, and we also believe these thresholds will promote greater certainty and reduced compliance burdens for issuers, while avoiding the risk of inundating audit committees and investors with voluminous and irrelevant information.

In conclusion, we recommend that the definitions hinge on whether there is a reasonable possibility individual or aggregated deficiencies would lead to a material adjustment in the financial statements, in the case of significant deficiencies, and on whether it is reasonably likely the deficiencies would lead to a material adjustment in the financial statements, in the case of material weaknesses.

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?

Providing examples in the Proposed Standard would perhaps be useful, but the examples in the Proposed Standard are limited in their usefulness. First, in the two examples of a significant deficiency, the PCAOB indicates compensating controls may prevent a significant deficiency from rising to the level of a material weakness. We agree with that premise but would also note that such controls could keep a deficiency from becoming a significant deficiency. Additionally, it is difficult to understand why Example D-1 (Reconciliations of Intercompany Accounts Are

Not Performed on a Timely Basis) would rise to the level of a significant deficiency or material weakness. Such intercompany accounts are eliminated in consolidation.

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

The auditor should only elevate internal control deficiencies where the significance and materiality are at an appropriately high level. There should be a threshold of significance below which the auditor relies on management

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?

No, refer to our response to Question 19.

Furthermore, as discussed in our cover letter, the Proposed Standard sets up an unwarranted escalation of non-significant and non-material items to the audit committee. "The auditor . . . is required to communicate to the company's management, in writing, *all* internal control deficiencies of which he or she is aware and to *notify* the audit committee that such communication has been made."[17]

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

We agree with the majority of the examples provided they are merely illustrative and do not impede the auditor's ability to take the facts and circumstances of each case into account. However, in some cases, the examples of ineffective internal audit, risk assessment, and regulatory compliance functions would extend beyond the Act's scope of financial reporting controls. In addition, in accordance with our response to Question 22, we would strike the example of ineffective audit committee oversight as the external auditor could have difficulty objectively evaluating the audit committee.

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?

No. There is the potential for compromised independence with the proposed evaluation process. An auditor cannot be expected to objectively evaluate the effectiveness of the committee that carries the responsibility for its continued employment and compensation.

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

No. Refer to our answer to Question 22.

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[17] PCAOB Release No. 2003-017, Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* 16 (Oct. 7, 2003) (emphasis added).

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. We do not believe this would be an appropriate response.

Questions regarding forming an opinion and reporting:

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?

In answering this question, we are assuming the PCAOB is referring to a situation where a material weakness exists as of the end of the period. In that circumstance, the SEC's rules make it clear that: "[m]anagement is not permitted to conclude that the [company's] internal control over financial reporting is effective . . . ."[18] To avoid confusing investors, the auditor should also express an adverse conclusion about the effectiveness of the company's internal control over financial reporting.

If, however, the material weakness has been identified and *corrected* prior to the end of the period, both management and the auditor could conclude the company's internal control over financial reporting is effective.

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

Yes. We believe qualified "except for" conclusions would actually allow for more meaningful public disclosure in certain cases. For instance, mergers and acquisitions occurring close to year end could warrant an "except for" conclusion. An adverse opinion in that circumstance could mislead the public to believe internal controls are not effective, when in fact, this is just a case of having inadequate time to fully assess the internal controls. Another example might be a case where a subsidiary representing an insignificant percentage of the parent's equity has a material weakness. As the Proposed Standard is drafted, the auditor would be required to issue an adverse opinion. However, this adverse opinion would do little to inform investors of the true nature of the deficiency or its effect on the overall control environment of the parent corporation.

[18] Final Rule: Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities and Exchange Commission Release Nos. 33-8238, 34-47986, IC-26068, 68 Fed. Reg. 36663 (June 18, 2003).

27. Do you agree with the position that when the auditor issues a nonstandard 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?

Consistent with our answer to Question 1, we believe the auditor should conclude on management’s written assertion, not opine on the effectiveness of the internal controls over financial reporting. The opinion would speak to management’s assessment and the basis of disagreeing with management’s assessment would be the auditor’s concern about the internal controls.

<u>Questions regarding auditor independence:</u>

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

No. It should be left to the discretion of individual boards of directors, based on the existing SEC guidance. Many boards, including Intel’s, already supply such guidance.

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

Yes, but we believe the existing SEC guidance is sufficient.[19]

<u>Questions regarding auditor's responsibilities with regard to management's certifications:</u>

30. Are the auditor's differing levels of responsibility as they relate to management's quarterly certifications versus the annual (fourth quarter) certification, appropriate?

In general, yes. However, the written representation requirements in paragraph 128 on page A-44 largely replicate the signed 302 certifications. The notarized 302 certifications should be sufficient representation.

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

Our answer to this question depends on the PCAOB’s interpretation of “limited procedures.”[20] If observation is broadly construed to include walkthroughs, it is an unnecessary change.

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[19] *See* Final Rule: Strengthening the Commission's Requirements Regarding Auditor Independence, Securities and Exchange Commission Release Nos. 33-8183, 34-47265, 35-27642, IC-25915, IA-2103, 68 Fed. Reg. 6010-17 (February 5, 2003).

[20] PCAOB Release No. 2003-017, Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* A-61 (Oct. 7, 2003).

Additionally, given there is no audit of the quarterly financial statements, walkthroughs would be inconsistent with the integration concept.

November 21, 2003

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

Re: Proposed Auditing Standards Concerning the Audit of Internal Control
(PCAOB Rulemaking Docket Matter No. 008)

The purpose of this letter is to respond on behalf of Irwin Financial Corporation to the proposed auditing standards for the audit of internal control over financial reporting performed in conjunction with an audit of financial statements. Irwin Financial Corporation is a diversified financial services company with $5 billion in assets that provides a broad range of consumer and commercial financial services in selected markets.

We believe, in general, that the Board's proposals to require greater oversight of internal controls by the external auditor will continue to enhance corporate governance practices and public confidence that registered companies in the United States have implemented and maintain appropriate control environments and systems of internal controls. However, we have some concerns regarding certain requirements in the proposal that we believe will result in substantial duplication of control testing and cost, and which will substantially exceed the benefits derived. Accordingly, our comments below address those specific issues in the proposal that are of greatest concern on our part.

The proposed standards equate the work performed by internal auditors with procedures and testing performed by management. The current proposal also places significant limitations on the ability of the external auditor to rely on the work of internal auditors. For example, the external auditor is required to perform all "walkthroughs" in each annual audit, all testing of information technology general controls, all work concerning evaluation of the control environment, including controls intended to prevent or detect fraud, and all testing of controls over the period-end financial reporting process. The standards also require that the external auditor's work must provide the "principal" evidence for their opinion.

We believe that the proposed standards are overly prescriptive and rigid. Based on our discussion with external auditors, these requirements will result in significant duplication of the work already performed by our internal auditors, significant increases in external audit costs, and significant disruptions to our operations as multiple parties review and test the same controls every year. We do not believe that such duplication and increased cost is necessary or warranted in most cases.

It appears that the prescriptive nature of the standards is based on a lack of comfort with the work performed by internal audit functions. In fact, the proposal does not distinguish between the work performed by internal audit and management. Most internal audit functions report directly to the audit committee of the Board of Directors, with the engagement, termination, and compensation of the Chief Audit Executive being determined by the Audit Committee, the same as in the case of the external auditor. Many internal audit functions are also highly professional, with staffs whose experience often exceed those of the external auditors participating in the examination of the company. On the other hand, control self-assessments or other control verification performed by management is not independent and may not be objective or completed by individuals with the appropriate level of expertise. Therefore, we believe that the standards should reflect these differences, and accordingly, the level of external auditor reliance that is appropriate based on the work of these groups should be differentiated.

We believe that the external auditor should have significant discretion in placing reliance on the work of internal audit and be able to rely on that work extensively, if deemed appropriate based on the quality of the internal audit function. Rather than placing significant restrictions on the use of internal audit work, we believe that it would be more appropriate to place standards that the internal auditor must satisfy in order for the external auditor to rely on their work. Standards established by the *Institute of Internal Auditors* or other professional organizations may be appropriate. Clearly, the external auditor must assess the independence, objectivity, competence and quality of the work performed by internal audit and their compliance with agreed-upon standards before they could conclude on their ability to rely on internal audit's work. Standards for such an assessment of the internal audit function are already addressed in SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, and could also be applied to the audit of controls over financial reporting. Based on the results of this assessment, the external auditor should then be able to place extensive reliance on the work of the internal auditor if it determines that it is appropriate based on the assessment of the internal audit function.

We believe this approach will also have positive side-benefits. Since weaknesses in internal audit functions will require greater external auditor validation of internal controls, and consequently greater cost, this will provide a significant incentive for board of directors and audit committees to raise the quality of their internal audit functions. Conversely, the currently proposed standards are likely to result in unintended consequences. Given the Board's responsibility to balance the expectations of various stakeholders, including shareholders, board of directors may conclude that the testing of internal audit functions is duplicative and unnecessary in those areas where the external auditor is not permitted to place reliance on internal audit work. This could result in situations where management certifications are solely based on management self-assessments, which may not be objective or verified by individuals who have expertise in risk and control analysis, with the independent validation left to the testing that the external auditor is required to perform. Therefore, we believe that the current proposals could result in decreased reliance in internal auditors and overall weakening of these independent risk and control oversight functions. Such an occurrence will actually result in reduced assurance on the quality of internal controls over financial reporting.

For example, although we currently have a small audit function consisting of 11 employees, the staff consists of professional auditors with an average of 11 years of audit experience and 19 years of financial services experience (including experience in senior financial reporting positions, such as controller, senior accounting managers, etc.). All of our internal auditors have at a minimum a bachelors' degree (primarily finance or accounting majors) with 36% having obtained a masters degree; 64% have obtained audit related professional certifications (CPA, CBA, CISA, etc.); and 36% of our staff have earned their CPA. We believe that continued investment in such an internal audit function will be difficult if the proposed standards limit the external auditor's ability to rely on their work, including reliance on the walkthroughs and I.T. general controls audits which are an integral part of our Corporation's internal audit processes.

The requirement that "the auditor must obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year" also appears excessive. We believe that the external auditor should have the discretion to use their judgment and risk assessment to determine the extent of testing necessary to support the opinion concerning the effectiveness of controls over financial reporting. The current proposal could result in significant testing in areas where no changes have occurred from prior audits and does not adequately differentiate for different levels of risk at different organizations. For example, the level of control testing necessary should be much different in an organization with a history of poor controls, negative surprises, and significant changes than in an organization that has a strong control environment and stable operations that have proven effective for many years, and where changes from previous years have been minimal. However, this requirement does not permit the external auditor to differentiate the level of testing necessary based on such risk assessments.

We also believe that it is inappropriate to require the external auditor to assess the effectiveness of audit committees. This is not practical and will place the external auditor in a significant conflict of interest since the audit committee is responsible for the engagement or termination of the audit firm, as well as approval of any non-audit services that the external auditor performs and the level of compensation for such services. This will again place the external auditor in a conflict of interest situation when the intent of various reforms in recent year has been to reduce or eliminate such conflicts.

We also do not believe that the external auditor is in a position to assess the effectiveness of the audit committee. Audit committee members generally include individuals with significant experience and expertise in a broad number of areas. In addition to the external auditor's interaction with the audit committee, the committee has substantial interaction with members of management, corporate risk management, the internal auditor, and others without the external auditor's participation. Such interaction is necessary and appropriate for the committee to ensure that it is receiving information that is unbiased. Accordingly, we believe that the external auditor is not in the best position, in terms of breadth of knowledge or involvement in all committee activities, to assess the effectiveness of the committee. Furthermore, audit committees are required to be constituted entirely of independent directors, at least one of whom is acknowledged to be a financial expert, and to conduct annual self-assessments. We believe that the board of directors of the company is responsible for the oversight of the self-assessment process and the overall evaluation of the effectiveness of the audit committee.

In conclusion, we believe that the proposed standards will result in significant duplication of internal control testing and unnecessary cost. We believe that the external auditor should have the ability to use significant discretion and judgment in determining the level of testing necessary to support their internal control opinion. We also believe that the proposed standards should eliminate any restrictions on the use of internal audit work and the current requirements that the external auditor's own testing must provide the principal basis for their opinion. Instead, internal audit work should be used extensively if the internal audit function meets specified requirements and the external auditor validates that those standards have been met. Finally, we do not believe that the external auditor is in an appropriate position to evaluate the effectiveness of the audit committee.

We thank you for the opportunity to comment on the proposed auditing standard.

Sincerely,

Will Miller

Will Miller
Chairman & CEO

cc: Audit & Risk Management Committee, Irwin Financial Corporation

From: jramsingh@jpsco.com
Sent: Wednesday, November 12, 2003 6:20 PM
To: Comments
Subject: PCAOB Rulemaking Docket Matter No 008

Hi,
Let me first of all introduce myself.
I am Juliet Ramsingh and I am the head of Internal Audit for the light and power company in Jamaica in which a US company has majority shareholding.

I have been through the briefing paper on the above and offer the following comments

1 I think the standard should have some basic listing of the controls that are expected to be assesed by management for their effectiveness, as all Public companies should have some commonalities. For example, cash collections, investments, purchasing, assets.

2 Also, since executives are usually the ones determining their own expenses including bonuses etc, I think it should be a requirement that some statement be made to the public on this. This is against the background that if executives are compensated on what profits are shown in the financials then you want to be alerted to any bias in the financial reporting which may be contrary to accounting standards.

Juliet Ramsigh

The JPSCo. Mindset:
"We act with integrity, we shape the future, we deliver results, we care about people, we act as one team, we have a winning attitude"

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November 21, 2003

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

RE: PCAOB Rulemaking Docket Matter No. 008 – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements.

Dear Mr. Secretary,

As an organization that provides companies with a variety of professional services, including internal control services, Jefferson Wells International appreciates the opportunity to provide our views on the above proposed standard. We would like to offer our perspective on several aspects of the standard that we feel warrant additional consideration by the PCAOB.

Originally founded to provide an independent alternative for internal audits, Jefferson Wells has long championed many of the concepts on which the proposed auditing standard is based, including the use of the COSO framework and the recognition of the role of internal auditors and qualified third parties in strengthening internal controls. Our comments on the standard relate to three areas:

- Reliance on work performed by internal audit and third parties
- Evaluation of the Audit Committee
- Independence

<u>Reliance on the Work Performed by Internal Audit and Third Parties</u>

We support the PCAOB's stance on the integrated audit and agree that to ensure independence, the external auditor should always perform a certain amount of the work. However, we feel that a distinction should be made between work performed by management and work performed by either independent internal auditors or qualified third parties who report to the Audit Committee. To the extent a company has an effective Audit Committee that includes an internal audit function reporting to it, the independent auditor should have the flexibility and discretion to rely further on the work performed by the internal auditors or third parties.

Allowing reliance on the work performed by other "independent" parties, such as the internal audit function, or third parties performing the role of internal audit, should be considered as long as the relied-upon work meets the standards of internal auditing as defined by the Institute of Internal Auditors, and is deemed to have met the criteria defined by the AICPA's Statement on Auditing Standards No. 65.

As long as it can be reasonably documented, consideration should also be given to allowing reliance of prior period testing results in areas determined to have no significant changes in approach from prior periods. At a minimum, we feel consideration should be given to the ability to modify the level of testing necessary in areas where no exceptions were noted in the prior period, and no changes in the process have been identified, with some upper time limit clearly established in order to ensure that changes do not go undetected.

In addition, we suggest consideration be given to using language which provides better guidance for operating management as to its role in ongoing testing, versus the roles of both the internal and external auditors, as it relates to control maintenance for annual assertions.

Evaluation of the Audit Committee

We are concerned about the inherent conflict that may arise in the independent auditors' role to evaluate the effectiveness of the Audit Committee. Audit Committees have a duty to hire and fire independent auditors. To have those same independent auditors assess the effectiveness of the Audit Committee creates an obvious conflict. Paragraphs 57 and 58 provide a general framework for assessing the effectiveness of Audit Committees. However, more specific guidance (perhaps in a format similar to that used in Appendix B for presenting testing guidelines) may be needed to provide more objectivity to both the auditors and Audit Committee as to the Board's expectations in this area.

Independence

Jefferson Wells feels strongly that external auditors should be prohibited from performing in any capacity in assisting operating management in the assessment, documentation and internal testing, gap analysis and/or remediation of potentially reportable conditions associated with preparing management's assertion for Section 404 of the Act. Performing even a small portion of this work places the external auditors in the position of management or of auditing their own work product, thus impairing the external auditors' ability to make an independent attestation on management's assertion.

Jefferson Wells believes that these are important issues, worthy of consideration by the Board, and we appreciate the opportunity to provide comments.

Sincerely,

George Herrmann
Vice President and Chief Financial Officer
Jefferson Wells International

The Public Company Accounting Oversight Board

Proposed Standard: Audit of Internal Control over Financial Reporting

Johnson & Johnson is pleased to comment on the proposed standard on Audit of Internal Control over Financial Reporting. We commend the Board for putting forth the concept and detailed requirements of an integrated audit of the financial statements and internal control over financial reporting. We believe this will contribute to further strengthening the investor confidence in the financial reporting process, internal control and the audit thereof.

The proposed standard discusses, amongst other items, the auditor's responsibilities and re-emphasizes principles and guidelines on auditor independence. It also discusses Management's documentation and testing requirements.

The proposed standard provides guidance on the Auditor's use of work of Management. More specifically, the proposed standard specifies that no use of Management's work can be made for the control environment or for 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. In other words, 100% external auditor testing is required for such controls. While we understand the auditor must perform enough work to provide evidence for the audit opinion, we believe 100% testing of certain controls is too strict and not cost effective in cases where Management has an adequate control structure in place and has adequately documented and tested controls. In many cases, Management's own testing will be supplemented with Internal Audit reviews that will include testing procedures independent from Management's own testing. The (external) auditor should be able to rely, to a certain extent, on such process. Internal Audit departments often perform very extensive work in the Information Technology area. Insofar as that process is considered to be effective by the (external) auditor, we believe it appropriate to allow the auditor to use, to a reasonable degree, the work performed by Management in such areas as Information Technology.

Please consider this observation in your deliberations on the final rules. It will be our pleasure to further clarify our point of view, if required.

Sincerely,

Ronald G. Fulop
Vice President
Corporate Internal Audit

Stephen J. Cosgrove
Corporate Controller

JPMorganChase

Joseph L. Sclafani
Executive Vice President and Controller

November 21, 2003

Via email: comments@pcaob.org
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Attention: Office of the Secretary

Re: PCAOB Rulemaking Docket Matter No. 008
PCAOB Release No. 2003-017

Ladies and Gentlemen:

J.P. Morgan Chase & Co. ("JPMorgan Chase") is pleased for this opportunity to comment on the auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements (the "proposed standard")*, proposed by the Public Company Accounting Oversight Board ("PCAOB").

JPMorgan Chase is a leading global financial services firm with assets of more than $750 billion and operations in more than 50 countries. JPMorgan Chase agrees with the basic principle enunciated by the PCAOB as to the importance of internal controls. Internal controls add value and mitigate risks, thereby enabling a company's management, board and shareholders to rely, with more reasonable assurance, upon the integrity of a company's financial reports. As a financial institution that has been, for over a decade, applying the framework recommended by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") to satisfy the requirements of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), JPMorgan Chase understands the importance of a strong internal control environment and supports the PCAOB's objective of creating an integrated audit of both financial statements and internal controls over financial reporting.

J.P. Morgan Chase & Co. ● 270 Park Avenue, Floor 28, New York, NY 10017-2070

Telephone: 212 270 7559 ● Facsimile: 212 270 9589
joseph.sclafani@chase.com

The comments which follow highlight four areas of the proposed standard that JPMorgan Chase believes require additional consideration by the PCAOB:

- The definitions of "significant deficiency" and "material weakness" should be modified
- The external auditor should be permitted to use the work of others, particularly that of the internal auditors, to a greater extent
- The external auditor should be given more latitude to determine the level and extent of the procedures and testing to be performed
- The proposed standard should permit the issuance of audit reports with "except for" opinions

1. Definitions of Significant Deficiency and Material Weakness

We agree with the PCAOB that material weaknesses be reported to the public, as we believe it is important to provide investors transparency about a company's internal controls. However, we do not believe that disclosure of such information should be based on a "more than remote likelihood" of occurrence.

We believe that the "more than remote likelihood" standard is too low a threshold by which to evaluate internal control deficiencies. In addition, it is a threshold that is lower than the threshold related to "reportable condition" and "material weakness" articulated under current auditing standards, particularly AICPA Professional Standards AU Section 325 and AICPA Attestation Standards AT Section 501. We believe that since the rules promulgated by the Securities and Exchange Commission pursuant to Section 404 of the Sarbanes-Oxley Act ("SOX 404") refer to AU Section 325 and AT Section 501, those standards should be applied in determining whether a significant deficiency or material weakness exists. Those standards are more appropriate than the “remote likelihood” threshold which is based on the concept of “remote” defined in Statement of Financial Accounting Standards No. 5.

The appropriate threshold for the definitions of “significant deficiency” and “material weakness” is a critical issue. Use of an inappropriately low standard will make the scope of work to be performed by management, the internal auditor and the external auditor too expansive without providing any meaningful benefit. The level of significance drives, among other things, the accounts and processes to be evaluated, the controls to be tested, the level of detail of the tests to be performed and the number of walkthroughs to be conducted. A too-low threshold has the potential of creating a vast range of work to evaluate and test processes and controls that may not be the key drivers of an effective internal control system, resulting in assessments and testing that are not value-added nor cost effective.

In addition, we are concerned a too-low threshold could potentially encompass deficiencies that will not have a significant effect on the financial statements. Disclosure of such deficiencies may actually mislead investors about the integrity of a company's internal controls. Even the most effective internal controls may not be able to prevent the occurrence of a control deficiency to a level that is "remote. " In any complex organization, control deficiencies may periodically arise in the normal course of business; most are detected and corrected in a timely fashion without the company incurring any material loss and without materially affecting the financial statements. While we strongly believe it is important to provide transparency about a company's internal controls, we also believe that setting an appropriate threshold for disclosure is necessary to ensure that investors are not provided information at such a level of insignificance that the disclosure becomes, in effect, a litany of "false alarms."

We therefore respectfully propose that the PCAOB, in defining the terms "significant deficiency" and "material weakness," use a "*reasonably likely"* threshold, a threshold which the PCAOB itself refers to in paragraph 183 of the proposed standard. We believe the "reasonably likely" standard is consistent with the concept of management providing (and auditors obtaining) reasonable assurance in an audit of internal controls. We also believe this term is more consistent with the term "reduce to a relatively low level" used in AU Section 325 and AT Section 501. In addition, we are concerned that the threshold of "more than inconsequential" in connection with "significant deficiency" will not clearly delineate a non-significant internal control deficiency from a significant deficiency. We therefore propose a threshold of "significant" misstatement, which will be clearer and also retain a distinction from material weakness.

We therefore propose that the PCAOB modify the definitions of "significant deficiency" and "material weakness" as follows:

- a "significant deficiency" is a "single deficiency, or a combination of deficiencies in the same or closely related reporting areas, that is *reasonably likely* to result in a *significant* misstatement of the annual or interim financial statements; and

- a "material weakness" is a "significant deficiency that, by itself, or in combination with other significant deficiencies, is *reasonably likely* to result in a *material* misstatement of the annual or interim financial statements."

In this way, control deficiencies that would pose a reasonable risk of material misstatement would be appropriately reported to investors and the public, while ensuring that significant deficiencies continue to be reported to management and the audit committee.

We further believe the list referred to in paragraph 126 is too prescriptive, as these items do not necessarily indicate, in all cases, the existence of a significant deficiency. We believe no specific list of circumstances should be presumptively regarded as "significant deficiencies"; rather, a significant deficiency must be evaluated based on all relevant facts and circumstances. For example, the evaluation needs to consider how the control deficiency was discovered, how long the deficiency had occurred before being discovered, and the magnitude of loss, if any, resulting from the deficiency. In addition, the proposed list does not take into consideration the fact that the deficiency was discovered, demonstrating that internal controls were functioning properly, nor does it take into consideration the existence of other controls that might exist that would prevent the identified deficiency from elevating to the level of a significant deficiency or material weakness. In our view, the examples do not permit sufficient exercise of the external auditor's professional judgment.

For the above reasons, we believe the definitions of significant deficiency and material weakness used in the standard should be more judgment-based and contain more realistic thresholds. In this way, the disclosure of the existence of material weaknesses will provide investors with information that is meaningful and material.

2. The Extent to which the External Auditor Should be Permitted to Use the Work of Others, Particularly the Work of the Internal Auditors

As currently proposed, the standard defines three categories of controls and sets forth, for each category, the extent to which the external auditor may – or may not – rely upon the work of others.

We believe that these categories are too rigid. Certain controls defined to belong in one category may more appropriately be included in another. For example, we believe there are controls, such as those that are related to period-end financial reporting (including controls over initiating, recording and processing general ledger entries), that relate to activities that are primarily routine and recurring. Accordingly, these controls should be ones where the external auditor be permitted to rely upon the work of others. In addition, with respect to “controls that are part of the control environment” and “information technology general controls” (controls which the PCAOB acknowledges are pervasive and upon which the effectiveness of so many other controls depends), it is important to recognize that these controls are generally subject to extensive reviews by internal auditors. Therefore, it may not be practicable for the external auditor not to rely upon the work of others; the blanket prohibition in the proposed standard on the use of the work of others with respect to these controls is, simply, not realistic and too costly. Finally, with respect to controls over significant non-routine and non-systematic transactions, the proposed standard does not provide the external auditor with sufficient flexibility in appropriately relying on the testing performed by internal auditors. We therefore believe the limitations imposed by the proposed standard as to how the external auditor must perform its own assessment are too inflexible.

In this regard, we believe the proposed standard does not give appropriate recognition to the work of internal auditors. The competency and objectivity of a company's internal audit function should be evaluated in light of the circumstances of each company, as each organization will differ; therefore, where appropriate, the proposed standard should permit more reliance by the external auditor on the work of internal auditors. For example, where internal audit reports directly to the audit committee, is independent of management, is highly trained and competent, is a significant element of the firm's control environment, is appropriately staffed with the necessary resources, is experienced in detecting control weaknesses, and where the results of internal audits are transparent to both the audit committee and the external auditor, requiring the external auditor to reperform significant amounts of testing done by the internal auditors is duplicative and inefficient.

By limiting and restricting the extent of reliance by the external auditor on the work of the internal audit function, the proposed standard may adversely affect the importance placed on the internal auditors; over time, the standard as currently proposed may have the unintended effect of diminishing the importance of the internal audit function within the organization and, particularly, as it relates to the audit of financial statements and controls over financial statements. This result would be counter to the intent of SOX 404 to improve the internal control environment of companies.

We therefore respectfully propose the PCAOB incorporate in the proposed standard an approach similar to that 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 permits the external auditor to rely upon the internal auditor's work in light of, among other things, the external auditor's assessment of the competency and objectivity of the internal auditors.

For the above reasons, we believe there should not be any rigid, tiered categorizations of areas defining the extent to which the external auditor may or may not use the work of others; rather, we believe the external auditor should be permitted to exercise its professional judgment as to the appropriate level of its reliance on the work of others, particularly the use of the work of the internal auditors.

3. <u>The Extent to which the Proposed Standard Should Permit More Latitude to the External Auditor to Use its Judgment to Determine the Level and Extent of the Procedures and Testing to be Performed</u>

We believe the external auditor should be permitted more flexibility with respect to the procedures and testing strategies employed. The nature, timing and extent of the procedures and testing should be based on the specific circumstances of the company. Factors to be considered should include the external auditor's evaluation of the entity's internal control processes, the effectiveness of the entity's internal audit function, the complexity of the transactions or processes being evaluated and whether there have been changes in the control environment.

With regard to testing, the external auditor should be given the latitude to determine whether it is necessary to perform testing each year with respect to each significant control function. If, for example, there has not been a significant change from the prior year in the process flow of transactions with respect to a routine control function, the proposed standard should permit the external auditor to determine if it would be appropriate to rely upon the prior year's evidence, in full or in part, with respect to the particular assertion being tested.

Likewise, more discretion should be permitted to the external auditor to determine the nature and extent of procedures to be performed in order to gain an understanding of process flows and the design and effectiveness of controls. In this regard, walkthroughs should not be mandated for every significant process. While walkthroughs are valuable tools, they are only one method of providing important audit evidence for external auditors; alternate audit procedures that meet the audit objectives should also be acceptable if deemed appropriate by the external auditor.

The prescriptive nature of the proposed standard will increase audit fees in a way that will not add value nor be cost effective to the control environment. Redundant work and burdensome procedures will not help companies or their investors. We believe the proposed standard should permit the external auditor to focus on the areas where, given its professional judgment and its knowledge of the company and its processes, there is the greatest potential for risk and where the costs to be incurred in connection with the audit have the greatest likelihood of identifying internal control deficiencies. The proposed standard should grant the external auditor the necessary latitude to use its professional skepticism in designing and executing the audit.

4. The Proposed Standard Should Permit the Issuance of an "Except For" Opinion in the Auditor’s Report

The proposed standard should permit the issuance of a qualified, "except for" opinion, in the audit report. We recognize that a company's management, in its Section 404 certification, may not provide a qualified certification; that is, if a material weakness in internal controls exists, management must conclude that the company's internal controls are not effective. In that situation, however, management would have the opportunity within the Management’s Discussion and Analysis section of its SEC filings to fully discuss the material weakness and management’s assessment of its impact.

We therefore believe that the external auditor should have the latitude, when the material weakness is not deemed to be so severe and pervasive as to warrant an adverse opinion, to issue an “except for” opinion. For example, if the material weakness is limited to a specific account or disclosure that does not taint the entire internal control environment, an "except for" opinion may be appropriate. Similarly, if the material weakness were discovered in the latter part of the fiscal year, there had been a prompt response by the company to develop corrective action, and good progress had been made to remedy the weakness, the external auditor might deem it appropriate to issue a report with an "except for" opinion. Additionally, an "except for" opinion may be the only viable opinion that an external auditor can deliver when an entity was recently acquired by the company.

For the reasons set forth above, we believe an "except for" opinion may provide a more appropriate assessment of a company's internal control environment. It allows the external auditors to describe any material weakness and its likely consequences to the financial statements, as well as the steps being taken by the company to correct the weakness. Disclosure of more information in this regard would be more helpful to investors than a "blanket" adverse opinion.

*****

JPMorgan Chase appreciates the opportunity to provide our views on this important matter. We believe our proposed modifications would improve the ability of companies to comply with the proposed standard, without weakening its effectiveness. We would be pleased to discuss our comments or answer any questions you may have.

Very truly yours,

From: Robert Schneider [rschnei@kimball.com]
Sent: Thursday, October 16, 2003 9:43 PM
To: Comments
Subject: Docket 008

Hard copy of the attached was mailed to the PCAOB today, October 16, 2003

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

October 16, 2003

RE: PCAOB Rulemaking Docket Matter No. 008 - Burden On U.S. Manufacturing Companies Greater Than Benefit

Dear Board Members:

I appreciate the Public Company Accounting Oversight Board's research and effort that clearly has been put into the proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*, and the opportunity for public comment. This Standard is pursuant to Section 404(b), among others, of the Sarbanes-Oxley Act of 2002.

It is commonly agreed that the Sarbanes-Oxley Act was rooted in the very significant and disturbing accounting scandals that became public immediately prior to the Act. Each scandal of course had different facts and circumstances but in my view, there were 3 common elements:

1. Lack Of Integrity Of Management & The Board
2. Lack Of Independence Of The Auditor
3. Lack Of SEC Oversight And Enforcement Of Existing Securities And Criminal Laws

The first item cannot be legislated; the second is being appropriately addressed by recent legislation and the third is also being addressed by increased staffing of the SEC and greater legal action being taken against companies, and more importantly, the individuals within companies that perpetrate frauds.

With respect to the passing of Sarbanes-Oxley legislation in 2002, many helpful changes were debated by Congress, and ultimately, included within the legislation. On the topic of internal controls, Congress included very specific language to keep management focused on the integrity of financial reporting. Section 404(b) of the Act states:

> *"(b) Internal Control Evaluation and Reporting.– with respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by management of the issuer."*

It is my view that our Congress men and women intended for this language to mean what it literally states, and not be subject to the interpretation of the Public Company Accounting Oversight Board. Specifically, public accounting firms should attest to the assessment made by management, not perform a detailed audit of internal controls. This is a very important distinction as a detailed audit of internal controls each year is extremely costly to American business and its competitiveness, and in the end, will not address the lack of integrity of management and the board, which is such an important cause of accounting scandals. The best of controls can be easily circumvented by unscrupulous management as you indicate in PCAOB Release No. 2003-017, Page 5:

> *"Regardless of how well any system of internal control over financial reporting is designed and operating, it cannot provide absolute assurance of achieving financial reporting objectives because of inherent limitations. These inherent limitations exist because internal control over financial reporting is a process that involves human diligence and compliance and, consequently, can be intentionally circumvented."*

It is my view that Congress recognized this fact and accordingly did not intend for a detailed audit of internal controls. They effectively balanced the value of a detailed audit with the cost to American business and its competitiveness.

Further, you indicate on Page 8 of Release No. 2003-17:

> *"...investors expect the independent auditor to test whether the company's internal control over financial reporting is effective, and the proposed auditing standard would require the auditor to do so."*

I do not agree with this. What I think investors want to know is simply if the numbers in the financial statements are correct or not and if the disclosures are correct or not. If the numbers and the disclosures are correct and complete, I do not think investors give weighty consideration as to *"how"* the numbers got to their reported correct state. In the end, investors know that internal controls are nothing more than a tool in running an effective business, and that the most important aspect to running an effective business for the long-term is the integrity of management and the board. And without that integrity, internal controls are ineffective, whether audited or not, in giving absolute assurance the numbers and disclosures in financial statements are correct.

As noted above, I think Congress knew this, and therefore did not intend for the PCAOB to write regulations requiring a detailed audit of internal controls. They did, however, see the value in having the public accounting firm attest to management's assertion of its internal controls, which is much less costly to American business.

The final analysis of this proposed Auditing Standard requiring a detailed audit of internal controls is that public companies across America will incur greater costs, will become uncompetitive with companies not subject to this standard; and in the end, all this cost and work on internal controls would not have stopped the accounting scandals that initiated the Sarbanes-Oxley legislation in the first place, as we cannot legislate integrity. It is important to note, though, that many aspects of the Sarbanes-Oxley legislation have had and will continue to have positive effects with respect to the 2^{nd} point (Lack Of Independence Of The Auditor) and the 3^{rd} point (Lack Of SEC Oversight and Enforcement Of Existing Securities and Criminal Laws); and in the end, it is these changes of real substance that give investors real confidence in the accuracy of financial reporting.

Sincerely,

Robert F. Schneider
Kimball International Inc.
Executive Vice President,
Chief Financial Officer, Treasurer

CC: Financial Executives International, Colleen Sayther, President and CEO

EVAN BAYH
INDIANA

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COMMITTEES:
ARMED SERVICES
BANKING, HOUSING, AND URBAN AFFAIRS
ENERGY AND NATURAL RESOURCES
SELECT COMMITTEE ON INTELLIGENCE
SMALL BUSINESS
SPECIAL COMMITTEE ON AGING

October 13, 2003

William McDonough
Chairman
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Dear Chairman,

Enclosed, please find a letter from Kimball International of Jasper, Indiana. Kimball International recently contacted my office regarding the Sarbanes-Oxley Act. Specifically, the corporation is concerned with section 404(b) which addresses internal control evaluation and reporting. Please include their comments in your rulemaking process. I am forwarding Kimball's letter to you for consideration during your public comment period.

Sincerely,

Evan Bayh

Fax

Name: Mary Moore Hamrick
Organization: PCAOB
Fax: 862-8436
Phone: 207-9165

From: Shellie Bressler
Office of Senator Richard Lugar
202-224-2526

Date: November 17, 2003
Subject: Comment Letter
Pages: 1

To follow up on our earlier discussion, at Senator Lugar's request, please include Mr. Douglas Habig's letter addressed to Senator Lugar in the official comments of the regulation.

Thank you for you consideration in the matter.

Shellie

From the desk of...

Kimball International

1600 Royal Street . Jasper, IN 47549
Telephone 812.482.1600

October 23, 2003

Senator Evan Bayh
463 Russell Building
Washington, DC 20510-1404

Senator Richard Lugar
306 Hart Senate Office Bldg
Washington, DC 20510-1401

Congressman Baron Hill
1024 Longworth
House Office Building
Washington, DC 20515

Dear Senators Bayh and Lugar, and Congressman Hill:

We are writing to you concerning a very important issue, not only for Kimball International, but for all American publicly held companies. We are also doing so because you are our elected Representative. We appreciate you as our "voice" in these matters and very much respect your leadership.

I am sure you are familiar with the proposed auditing standard recently published by the Public Company Accounting Oversight Board (PCAOB) as a result of direction given in the Sarbanes-Oxley Act under Section 404(b). We may be one of the first companies to contact you about this issue because we are a June 30 year-end company, and, as such, are one of the required "early-adopters" of the standard.

While certainly the past conduct of far too many U.S. corporations was egregious and unconscionable, it was still a small minority of American companies. Congress was wise to take prompt action to pass legislation which we all hoped would curb and prevent any further abuse, conflict of interest in the large public accounting firms, as well as restore public confidence in our stock markets.

However, we believe strongly that with this PCAOB standard on Section 404(b), the pendulum has swung much too far to the side of overly burdensome regulation which will continue to erode the competitiveness of American companies. All of this comes in an environment of incredibly intense international competition, especially from China. The regulatory burden and costs imposed by the PCAOB standard will further add to the cost structure of American business. These costs cannot be recovered from our customers and will drop us further behind in our competitiveness with Asian and other countries which are not burdened by such regulations.

To illustrate our point, we have already seen proposed increases in our audit fees for the internal control audits required by the PCAOB pronouncement in the neighborhood of nearly 90%. We estimate our internal compliance costs (our personnel, time in documenting processes, dealing with the external auditors, etc.) for our fiscal year ended June 30, 2004, in excess of $1.5 million.

This is a real cost that will be incurred annually and is in addition to rapidly increasing healthcare costs and a doubling of commercial insurance (D&O, Liability). Unfortunately, like many public U.S. manufacturing companies, this has left us no choice but to seek lower cost manufacturing geographies around the world to remain competitive. We know you are keenly aware of these factors and the resulting loss of U.S. manufacturing base and employment.

While no company is perfect, Kimball has, in the 50 years of its existence, prided itself on our Guiding Principles (copy enclosed) which have served us well in guiding our behavior and decision-making. We had ethical principles of business conduct published well before Sarbanes-Oxley was enacted. Our sense is that the vast majority of public companies did not need these regulations to conduct their business with high ethics, professionalism, transparency, and full disclosure. We know you are as committed in your leadership as we are in ours. Clearly the tone is set at the tope of any organization. The character of your leadership is very much appreciate and admired by those of us leading public companies like Kimball International, Inc.

We have watched the developments over the last 2 ½ years with the same disgust and disappointment that I am sure you have seen, but we feel that this PCAOB pronouncement is the proverbial "straw that breaks the camel's back". We think the PCAOB has exceeded its authority under Sarbanes-Oxley with this recent standard. Those regulations will cause controls to become an end in themselves. They bring the ultimate conflict of interest in self-evaluation by audit committees of boards and audit firms. And finally, the regulations give plaintiff lawyers a powerful tool to unfairly transfer the wealth of shareowners and drive very professional, high integrity executives away from service on public boards.

We would ask that as our elected representative you use whatever options might be available to you to attempt to see that this burdensome standard is not enacted. A further detailed explanation of our rationale is included in our CFO's comment letter of October 16th to the PCAOB which we have also enclosed.

We thank you very much for your consideration of this important matter. We would be more than happy to discuss this with you or your staff if you so desire. We thank you for your continued high integrity service and congressional leadership of this great country.

Sincerely,

KIMBALL INTERNATIONAL, INC.

Douglas A. Habig
Chairman, Chief Executive officer

James C. Thyen
President

Kimball International

1600 Royal Street Jasper, IN 47549
Telephone 812.482.1600

October 16, 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 - Burden On U.S. Manufacturing Companies Greater Than Benefit

Dear Board Members:

I appreciate the Public Company Accounting Oversight Board's research and effort that clearly has been put into the proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statement,* and the opportunity for public comment. This Standard is pursuant to Section 404(b), among others, of the Sarbanes-Oxley Act of 2002.

It is commonly agreed that the Sarbanes-Oxley Act was rooted in the very significant and disturbing accounting scandals that became public immediately prior to the Act. Each scandal of course had different facts and circumstances but in my view, there were 3 common elements:

1. Lack Of Integrity Of Management & The Board
2. Lack Of Independence Of The Auditor
3. Lack Of SEC Oversight And Enforcement Of Existing Securities And Criminal Laws

The first item cannot be legislated; the second is being appropriately addressed by recent legislation and the third is also being addressed by increased staffing of the SEC and greater legal action being taken against companies, and more importantly, the individuals within companies that perpetrate frauds.

With respect to the passing of Sarbanes-Oxley legislation in 2002, many helpful changes were debated by Congress, and ultimately, included within the legislation. On the topic of internal controls, Congress included <u>very specific language</u> to keep management focused on the integrity of financial reporting. Section 404(b) of the Act states:

> *"(b) Internal Control Evaluation and Reporting.– with respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by management of the issuer."*

It is my view that our Congress men and women intended for this language to mean what it literally states, and not be subject to the interpretation of the Public Company Accounting Oversight Board. Specifically, public accounting firms should attest to the <u>assessment made by management</u>, not perform a detailed audit of internal controls. <u>This is a very important distinction</u> as a detailed audit of internal controls each year is <u>extremely costly</u> to American business and its competitiveness, and in the end, will not address the lack of integrity of management and the board, which is such an important cause of accounting scandals. The best of controls can be easily circumvented by unscrupulous management as you indicate in PCAOB Release No. 2003-017, Page 5:

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Further, you indicate on Page 8 of Release No. 2003-17:

"...investors expect the independent auditor to test whether the company's internal control over financial reporting is effective, and the proposed auditing standard would require the auditor to do so."

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Sincerely,

Robert F. Schneider

Robert F. Schneider
Kimball International Inc.
Executive Vice President,
Chief Financial Officer, Treasurer

CC: Financial Executives International, Colleen Sayther, President and CEO

David Kowalczyk
dkowalczyk@yahoo.com
7 Georgetown Court
Basking Ridge, NJ 07920

November 13, 2003

Office of the Secretary
PCAOB
1666 K Street NW
Washington, DC 20006-2803
comments@pcaobus.org

Dear Sirs:

RE: PCAOB Rulemaking Docket Matter # 008

I offer these comments on selected questions raised in your exposure draft:

Overview:
The Standard obviously addresses the role of the external accountant. The external accountants seem to have significant breadth of scope when this standard is implemented. Considering this is ONLY for financial reporting, the breadth seems too broad. Accordingly, the third party and internal audit work product is relegated to review routine transactions only. This does not make sense. The external auditor does not have the resources to accomplish all that is required; and the corporate world cannot afford to pay for this breadth of scope. This is the equivalent of another full audit – every year? The external accounting firms are the same firms that are not to do internal control work per prior SEC and NYSE requirements.

Detailed responses to questions:
Question #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?

Answer: NO; however, maybe you do not need to give further direction.

Question #10: Is it appropriate to require that the walkthrough be performed by the auditor his/herself rather than allowing the auditor to use walkthrough procedures performed by management, internal auditors, or others?

Answer: YES and NO, the external public accountant should be able to use the work of others to perform his/her walkthrough. By using other's documentation (and presuming it is accurate), "walking through" the process(es) will take less time, effort and money than having the external accountant perform this exercise "from scratch." The documentation effort is time-consuming. Is this to be done every year? Can this be phased-in and then continually performed over three years?

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

Answer: It all depends on the quality of the personnel performing the work (and the same can be said for any team – internal or external to the organization). The quality of the other individuals performing the work could be more qualified and/or far superior than the quality of work performed by a CPA. As an example, a competent internal audit staff will probably have more internal control knowledge of the Information Technology infrastructure, and far more knowledge of the Control Environment than any external resource. There has to be a way of effectively and efficiently using that information. It would make more sense for the documentation to be made available for the external accountant to verify and then test, or spot-check.

Question #13: Are the 3 categories of controls and the extent to which the auditor may rely on the work of others appropriately defined?

Answer: No, they are far too limiting. Whose assertion is it? What is the extent of audit work necessary to opine on management's assertion? This is far too expensive and wasteful. Is this in accordance with the spirit and intent of the law? See my comments to Q#12 as to two examples of areas that can be documented and tested by competent internal resources and reviewed and test-checked by the external accounting firm. The more non-routine the process, the more work the external accountant will have to perform him/herself.

Question #14: Does the proposed standard give appropriate recognition to the work of internal auditors?
Answer: No.

If not, does the proposed standard place too much emphasis and preference on the work of internal auditors or not enough?

Answer: Not enough. Please understand, a significant quantity of internal auditors were previously external accountants. Many have certifications including CPA and CIA, among other certifications. Most internal auditors have more years of business experience than the senior accountants that will perform the majority of the certified external accounting work

By not allowing external accountants to rely on internal audit documentation (at a minimum) and testing, your proposed Auditing Standard diminish the worth and value of internal audit work in those corporations - where they do add significant value.

From my experience, internal auditors can know more about the risks, the Information Technology Infrastructure, Enterprise Risk Management, Risk Management, the Control Environment as well as the Information and Communication and Monitoring aspects of Internal Control than the public accountants could ever afford to know over three years (average length of time it will take for the external accountants to fully document and understand the nuances of significant processes) of auditing a major corporate client. Internal audit can develop and maintain a working knowledge and rapport which can be more effective than a team of accountants that are doing a walk-through over two or three weeks. How can external accountants do the non-routine processes, fraud reviews, and information technology infrastructure in an abbreviated time frame?

Question # 17: Will the definitions in the proposed standard of **significant deficiency** and **material weakness** provide for increased consistency in the evaluation of deficiencies?

Answer: I cannot image how. If a **significant deficiency…** "results in more than a remote likelihood that a misstatement of the … financial statements that is more than inconsequential in amount …" Remote means… slight.
If a **material weakness** is a significant deficiency that … results in more than a remote likelihood that a material misstatement … will not be prevented or detected."
So, in this wording, are we dealing with 6 sigma for "remote?" Is "more than a remote likelihood," "6 sigma plus one?" FASB Statement #5 Paragraph 3 is, in my opinion, poorly worded and far from definitive and thus should not be used. Where are "slight" and "likely" defined?

How can the definitions be improved?
By giving straightforward, meaningful, definitive definitions that can be finitely correlated to probability or some words of substance.

Question #18: Do the examples in Appendix D of how to apply these definitions in various scenarios provide helpful guidance?

Answer: Yes, to some degree.

Are there other specific examples that commenters could suggest that would provide further interpretive help?

Answer: Yes.

Examples:
1 – Of Pervasiveness: Correlate to the depth, breadth and organizational (executive or local) level within the corporation:

2 – When would an aggregation of significant deficiencies NOT constitute a material weakness?
3 – Examples describing a) Organizational segregation of duties issues; b) Incompetence; c) A strong overbearing personality of CEO/President to circumvent internal controls (by intimidation); d) The impact of compensating controls (insurance et al) on control deficiencies.
4 – What is the value of a SAS 70 review (performed by a PCOAB-registered external accounting firm) as it relates to the internal controls at an outside service provider?

> **Outside Service Audits:**
> An additional meaningless exercise has been SAS 70 reviews. What do they indicate? What value do they add? As you address outside service agreements, perhaps you can add some teeth to SAS 70 reviews. SAS 70 "comfort letters" are the current "standard" that applies to outside service audits.
> Are you aware of any organization who ever "failed" a SAS 70 review? SAS 70 reviews, as currently performed have minimal to no value for SOX 404 reviews.

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

Sure, did not the SROs say they couldn't perform these audits? Isn't this what caused/ started the demise of the CPA profession (e.g. Arthur Andersen)?

Most CPAs are NOT trained to review for fraud, and they typically do not find it. In two of the more publicized bankruptcies, the internal auditors found the improper accounting treatment and raised the issue. So why are you considering leaving the evaluation of the controls over the prevention of fraud to only the public accountants? The CPA profession has been trying (for decades) to disclaim responsibility for the review of fraud.

Questions # 30 & 31:
Commentary: Your questions add additional confusion as the purpose and intent of SOX Sections 302 and 404. Are they to be different?

When the "interpretation" came out stating that 404 was only for the reliability of financial statements as of a point in time; and did not include the COSO segment referring to adherence to laws and regulations, I did not understand this interpretation.

Let us go back to the implied purpose and intent of SARBOX and then answer these questions. According to the prior "guidelines," (SEC official statements) - if a material control weakness was corrected in Q2, Q3 or Q4 and was in place and operating "as of year-end," my interpretation of your prior statements is: Yes, the material control weakness was corrected as of year-end (a point in time). Is the process in effect and operating during a significant period covered by the financial statements – no or probably not!

If you violate the law (COSO Laws and Regulations) – Can it have a significant impact on the financial statements? – Sure. – Is it an internal control weakness? – Sure.
How can this segment of COSO be excluded?

This Standard is an excellent tutorial and overview of internal control documentation, and of what was taught previously by the Big-8. It is too bad the public accountants stopped auditing in this fashion. **We need to get back to the basics.** The SOX 404 work appears to reintroduce the concept of "permanent files" updated annually during the current year "preliminary work." Congratulations, a very good Audit Standard for audit documentation!

Respectfully,

David Kowalczyk

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New York, N.Y. 10017
8th Floor

Telephone 212-909-5600
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November 21, 2003

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

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*

Dear Mr. Secretary:

KPMG appreciates this opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or Board) Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements* (Proposed Standard). KPMG also recognizes and acknowledges the significant efforts of the PCAOB staff as evidenced by the comprehensive nature of the Proposed Standard.

We agree with the Board that the existing Interim Standards pertaining to the conduct and reporting of an auditor's attestation on internal control over financial reporting (ICOFR) is not sufficient to effectively implement the requirements of the Securities and Exchange Commission's (SEC) rule implementing Section 404 of Sarbanes-Oxley. We believe that the Board's Proposed Standard represents a significant improvement over the relevant Interim Standards and hope that the comments and observations included in this letter will assist the Board in finalizing a standard on audits of internal control. KPMG fully supports the Board's efforts to improve financial reporting, corporate governance and audit quality with the objective of furthering the public interest and restoring confidence in our capital markets system.

This letter is organized by first providing a number of general observations and comments on the Proposed Standard followed by responses to the specific questions posed in PCAOB Release No. 2003-17 that includes the Proposed Standard as an appendix. Less significant and editorial comments and suggestions are included in Appendix A to this letter.

General Observations and Comments

Use of the term "all." Auditing standards historically have not included the term "all" as audit evidence generally is obtained on a test basis and test item selection and sample sizes are principally a matter of auditor judgment. In addition, it may not be possible for an auditor to evidence compliance with a standard that requires an evaluation or assessment of "all" of a particular item. We suggest that the Board reconsider the propriety of using the term "all" in its final standard, principally due to the belief that use of such term may establish an unachievable threshold. For example, we believe the Board should reconsider use of the term "all" in the following paragraphs:

- In paragraph 24, "The auditor should evaluate **all** controls specifically intended to address the risks of fraud…"

- In the monitoring section of paragraph 50, "The auditor's understanding of management's monitoring of controls extends to and includes its monitoring of **all** controls, including control activities..."

- In paragraph 79, in reference to walkthroughs, "…the auditor should trace **all** types of transactions and events, both recurring and unusual…"

- In paragraph 114, in reference to the auditor's evaluation of evidence, "…the auditor should review **all** reports issued during the year by internal audit…that address internal control over financial reporting and evaluate any deficiencies identified in those reports."

- In paragraph 191, "…the auditor should communicate to management, in writing, **all** deficiencies in internal control over financial reporting…" (Also see response to Question 20 below)

Changes to other standards. We note that, in several instances, provisions of the Proposed Standard modify existing Interim Standards adopted by the Board. For example:

- Paragraphs 139 and 140 of the Proposed Standard provide conditions that should be met and factors that should be evaluated before performing substantive analytical procedures. (Modifies AU Section 329)

- Paragraph 141 refers to a substantive procedure requiring reconciling the financial statements to the accounting records and examining material adjustments made during the course of preparing the financial statements. (Modifies AU Section 316)

- Paragraphs 190 to 193 refer to requirements for communication of internal control matters to audit committees. (Modifies AU Section 380)

We encourage the Board, in its final standard, to identify each instance in which the final standard modifies the Interim Standards to help ensure consistent application of the provisions of the modified Interim Standards by auditors.

Authoritative appendices. We note in the Board's Statement of Authority that, "…appendices to the Board's standards are an integral part of the standard and carry the same authoritative weight as the body of the standard." We believe that appendices generally should be used for informational or illustrative purposes and should not carry the same authoritative weight as an auditing standard. In addition, we note that the Board's Interim Standards include a number of appendices that historically have not been viewed as carrying the same authoritative weight as the respective standards. In Appendix D to the Proposed Standard, we note that, while the information is intended to be illustrative, use of phrases such as "the auditor should determine" may be interpreted to establish imperatives in similar fact patterns.

Considerations for small and medium-sized issuers. The fundamental tenets of internal control apply equally to entities of all sizes and complexity. While the level of formality embedded in ICOFR may vary between entities of different size, paragraph 27 of the Proposed Standard indicates that, "…the auditor must 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." We believe the information provided in Appendix E of the Proposed Standard may inadvertently serve to create a separate, and lower, standard of internal control for smaller issuers. We believe that the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) report, *Internal Control – Integrated Framework*, adequately addresses smaller entity considerations and recommend that Appendix E be eliminated from the final standard.

Safeguarding of assets. Appendix C of the Proposed Standard provides examples of intentional and unintentional misstatements arising from deficiencies in controls over safeguarding of assets. We believe the information included in Appendix C and the provisions of the Proposed Standard addressing safeguarding of assets, while helpful, do not sufficiently address the question of which safeguarding controls should be considered within the scope of ICOFR. For instance, determination of an acceptable inventory shrinkage level due to theft is a management decision related to safeguarding of assets, but has financial reporting implications in the form of establishing an adequate reserve for such shrinkage. We suggest the final standard provide additional guidance on matters for the auditor to consider when identifying those safeguarding controls that directly affect ICOFR.

Inadequate documentation. Paragraphs 46 and 47 of the Proposed Standard indicate that inadequate documentation of the design of controls over relevant assertions related to significant accounts and disclosures represents a deficiency in ICOFR. We believe that inadequate documentation is an internal control deficiency, the severity of which should be evaluated by the auditor. The evaluation of inadequate documentation should be based on the individual facts and circumstances of the particular entity and such inadequacy should not automatically rise to the level of a significant deficiency or material weakness in internal control. This notion is consistent with our expectation that deficiencies in documentation may encompass a wide range of severity and are not necessarily subject to a predetermined assessment.

Information technology. Paragraph 70 of the Proposed Standard references paragraphs 16 through 20 of AU Section 319, *Consideration of Internal Control in a Financial Statement Audit*, regarding the nature and characteristics of the use of information technology in an entity's ICOFR. AU Section 319.19 indicates that one of the specific risks of information technology (IT) is, "Reliance on systems or programs that are inaccurately processing data..." This risk may arise when an entity relies on a program or system to perform a function (e.g., calculate, accumulate, etc.) that has no specific application controls (either within the program or manual controls) to ensure that it is appropriately processing information.

The lack of an application control may be mitigated by an IT general control, such as the review and testing of the system during development or implementation. However, to the extent that the application has been in place for a substantial period of time, the auditor may not be able to ascertain that the appropriate extent of testing was performed during system development. Further, many companies do not extensively test the processing accuracy when implementing a third party application.

The Board should consider further discussion in its final standard of the effect of IT on the auditor's consideration of internal control, and provide guidance in those situations where there is little, or no, direct control over the processing of information within an IT application.

Reporting. The reporting guidance provided in paragraph B16 of the Proposed Standard indicates that, should management and the audit committee not respond appropriately to auditor communications regarding certain consolidation matters, the auditor's report should include an explanatory paragraph describing the reasons why management's disclosure should be modified. In these instances, we believe that the auditor's report should disclose a scope limitation, rather than include an explanatory paragraph.

We note that the Proposed Standard contemplates a situation where the auditor reaches a conclusion that a material weakness has been identified; yet management has not disclosed the same matter in its report (paragraph 163). In this situation, it would appear that the Proposed Standard contemplates the auditor issuing an adverse opinion and management reaching a conclusion that its ICOFR is effective. We also note that the SEC does not accept auditor's reports on financial statements that are qualified as to scope or accounting principle (refer to Codification of Staff Accounting Bulletins, Topic 1E). We encourage the Board to coordinate efforts with the SEC staff to provide guidance to issuers and auditors on the SEC staff's willingness to accept the different forms of reporting and situations contemplated in the Proposed Standard.

Responses to Individual Questions

Our responses to the questions outlined in PCAOB Release No. 2003-17 that includes the Proposed Standard as an appendix follow:

Questions regarding an integrated audit of the financial statements and internal control over financial reporting:

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?**

   Yes. We believe such reference reinforces the notion of an integrated financial statement and internal control audit.

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?**

   No. We believe that an auditor can perform an audit of ICOFR without also auditing the entity's financial statements as of that date. While not commonplace, an entity may request, pursuant to contractual or regulatory requirements, an audit of ICOFR as of a date other than its financial reporting year-end. We recommend that the final standard not limit an audit of an entity's ICOFR to those instances when the auditor also is conducting and reporting on an audit of the entity's financial statements. We do believe, however, that an audit of an entity's ICOFR as of a date other than its financial reporting year-end is appropriate only if the entity's most recent year-end financial statements have been audited.

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?**

As stated in response to Question 2 above, we believe that an auditor can conduct and report on an audit of ICOFR without also performing an audit of the related financial statements, assuming that the entity's most recent year-end financial statements have been audited. We do not believe that it is necessary to perform procedures *comparable* to that required to complete a financial statement audit in order to conduct and report on ICOFR. In addition, the term "comparable" is subject to wide interpretation and does not adequately define the extent of procedures that might be necessary in such circumstances.

Question regarding the cost and benefits of internal control:

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?

We believe that the underlying concepts regarding ICOFR do not discriminate based on the size of any particular entity. The application of auditing standards in general is subject to auditor judgment and is dependent on a number of factors, including the size and complexity of the particular entity. We believe that the Proposed Standard provides a framework for the audit of ICOFR for all entities, regardless of size. In addition, we believe that the guidance provided in Appendix E is incomplete and does not address a number of issues applicable to the audit of ICOFR for small and medium-sized entities. Accordingly we recommend the elimination of Appendix E in the final standard adopted by the Board. As an alternative, the Board may consider referring to existing guidance on internal control for small and medium-sized companies provided in the COSO report, *Internal Control – Integrated Framework*.

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.

No. Existing Interim Standards (AU Sections 210, *Training and Proficiency of the Independent Auditor*, and 311, *Planning and Supervision*) provide guidance for professional competence, training and supervision of audit staff. We do not believe it is appropriate for an individual auditing standard to prescribe the level of competency and training of personnel required to conduct auditing procedures. This is a matter of judgment by the auditor with final responsibility for the audit.

Any such prescribed requirements would be, by their very nature, arbitrary, not applicable in all circumstances, and incomplete.

Questions regarding evaluation of management's assessment:

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. We believe the scope of the audit of ICOFR articulated in the Proposed Standard is appropriate. In addition, we believe that the scope of the audit would be better understood by all interested parties if the auditor's report spoke directly the effectiveness of ICOFR, rather than management's assessment. Accordingly, we suggest that the Board consider requiring that the auditor report directly on the effectiveness of ICOFR in all situations.

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

   Yes. We believe that the guidance provided in the Proposed Standard would serve to enhance the consistency of documentation prepared and maintained by management in supporting its assessment of ICOFR. However, we believe that management should maintain sufficient documentation for locations and businesses that are not considered significant, either individually or in the aggregate, to evidence compliance with existing books and records requirements under the securities laws.

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?**

   We believe that inadequate documentation is an internal control deficiency, the severity of which should be evaluated by the auditor. The evaluation of inadequate documentation should be based on the individual facts and circumstances of the particular entity and such inadequacy should not automatically rise to the level of a significant deficiency or material weakness in internal control. This notion is consistent with our expectation that deficiencies in documentation may encompass a wide range of severity and are not necessarily subject to a predetermined assessment.

KPMG

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?

We believe that walkthroughs represent an effective means of obtaining an understanding of an entity's ICOFR and an important component of an auditor's related evaluation. We support the requirement outlined in the Proposed Standard for the performance of walkthroughs for the entity's significant processes.

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?

While we agree that, in obtaining an understanding of an entity's ICOFR, walkthroughs should be performed, we do not believe that auditors should be prohibited from using the documented work of others in conducting walkthroughs. We suggest that the Board consider limiting the extent to which the auditor may use the work of others in the performance of walkthroughs, consistent with guidance outlined in paragraph 105 of the Proposed Standard.

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?

We believe that the auditor should obtain evidence of effectiveness of controls for relevant assertions for significant accounts and disclosures each year. However, we also believe that the nature, timing and extent of test work directed toward relevant assertions can, and should, vary from year to year based on prior years' findings, changes in a company's internal control, or changes in management. We recommend that the Board consider including language in its final standard clearly stating that the auditor may not rely on specific audit evidence obtained from specific audit tests performed in prior years to support his or her current opinion on ICOFR.

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?

Auditors should not be required to use the work of management or others in evidencing compliance with the performance provisions of an auditing standard. An auditor's conclusions regarding using the work of management and others are based solely on the auditor's judgment. The factors outlined in paragraph 103 of the Proposed Standard represent appropriate matters for the auditor to consider when evaluating whether to use the work of management and others. However, we recommend that the Board consider emphasizing the level of competency and objectivity of management and others currently addressed in paragraph 107 of the Proposed Standard as a factor for the auditor to consider when evaluating whether to use the work performed by management or others.

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

In general, we agree with the three-category approach outlined in the Proposed Standard for determining the extent to which the auditor may use the work of others. However, we have several comments regarding specific control types and control activities identified in the individual categories:

- The second bullet point in paragraph 104 of the Proposed Standard requires auditors to independently test controls over the period-end financial reporting process. We believe the nature of these controls are more appropriately categorized as a control over a significant process identified in paragraph 105 of the Proposed Standard and, as such, should allow for limited use of the work of others.

- Under the third bullet point in paragraph 104, "Controls that have a pervasive effect on the financial statements, such as certain information technology general controls," are required to be tested by the auditor. Internal audit personnel in many entities possess the skills and objectivity to effectively perform tests of information technology general controls. We believe that these controls should be considered in the same light as controls over significant non-routine and nonsystematic transactions and, accordingly, are more appropriately categorized as controls for which the auditor's use of the work of others should be limited as discussed in paragraph 105 of the Proposed Standard.

- Paragraph 106 of the Proposed Standard indicates that the auditor has the ability to use the testing results of management and others "without specific limitation" for controls over routine processing of significant accounts and disclosures. One could interpret "without specific limitation" to indicate that the auditor may rely solely on the work of others in certain instances. We recommend that the Board provide additional guidance in its final standard regarding the meaning of "without specific limitation." In that regard, we believe that the auditor should not rely solely on the work of others in the areas identified in paragraph 106 of the Proposed Standard.

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?

Yes. We believe the Proposed Standard, in paragraph 108, provides appropriate recognition to the work of internal auditors.

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)?

We believe that flexibility in determining the extent of reperformance of the work of others is appropriate as auditor judgment is required in assessing the level of auditor reperformance. For example, the auditor's evaluation of the competency and objectivity of an entity's internal audit function may influence the extent of auditor reperformance of internal audit's work.

16. Is the requirement for the auditor to obtain the principal 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?

Yes. We believe that the auditor should obtain, through his or her own work, the principal evidence for conducting an audit of and reporting on ICOFR. We believe that this notion is necessarily based on a number of subjective determinations and is not susceptible to objective measurement. Accordingly, we believe that the final standard should specifically make reference to the fact that, because controls over certain areas are not always susceptible to mathematical measurement, the auditor will need to apply judgment to determine whether he or she has obtained the principal evidence in support of the auditor's opinion.

Questions regarding evaluating results:

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?

Evaluating the severity of an internal control deficiency requires a high degree of judgment and, accordingly, is not conducive to a high degree of consistency in application. The Proposed Standard identifies several instances of internal control deficiencies that ordinarily would be considered significant deficiencies or, potentially, material weaknesses, thereby enhancing the level of consistency in practice relative to those particular matters.

We believe the definition of the term "significant deficiency" in the Proposed Standard is too broad and represents a significant departure from the current definition of a reportable condition in AU Section 325. Included in the definition of a significant deficiency in the Proposed Standard is "…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." In reference to this definition, we believe there will be few internal control deficiencies identified where the likelihood of a potential misstatement is "remote" and the magnitude of such a potential misstatement is "inconsequential." In fact, this definition could lead to literally every misstatement identified during the course of a financial statement audit resulting in at least a significant deficiency.

The varying magnitude of potential financial statement misstatements between those considered inconsequential and those considered material represents a wide range of possibilities. We believe that the Board should consider revising the definition of a significant deficiency to more clearly reflect those matters coming to the auditor's attention that adversely affect the entity's ability to initiate, record, process and report reliable external financial data (consistent with the definition of a significant deficiency in report examples A-2 and A-3 in Appendix A of the Proposed Standard). To that end, we suggest that the following replace the second sentence of paragraph 8 of the Proposed Standard: "A significant deficiency is an internal control deficiency or an aggregation of such deficiencies that could result in a misstatement of the financial statements that is more than inconsequential." We believe that the definition of a significant deficiency in the Proposed Standard will ultimately and inadvertently dilute the importance of significant deficiencies and the related responses by management, the audit committee, the board of directors, and others to such deficiencies.

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?

Use of examples to demonstrate the application of concepts in the Proposed Standard to an individual fact pattern may be useful to auditors. However, we note the following in the Board's Statement of Authority: "Additionally, appendices to the Board's standards are an integral part of the standard and carry the same authoritative weight as the body of the standard." We do not believe it is appropriate to include examples such as those evidenced in Appendix D in an auditing standard, but rather believe such examples are more appropriately included in non-authoritative implementation guidance. The possibility exists that practitioners may draw analogies to alternative fact patterns, resulting in inappropriate conclusions. In addition, examples have a tendency to take on definitional status over time and, accordingly, result in a dilution of judgment influencing an auditor's ultimate evaluation.

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

Upon becoming aware of internal control deficiencies, we believe that the auditor should evaluate the severity of such deficiencies, in much the same manner as the auditor evaluates identified misstatements to the entity's financial statements.

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?

We believe it is appropriate for the auditor to communicate to management in writing all internal control deficiencies identified by the auditor during the audit. We recommend that paragraph 191 of the Proposed Standard be revised to clarify that the auditor is responsible for communication to management only those internal control deficiencies *identified* by the auditor.

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

We have a number of comments on this subject:

- With regard to the first bullet point in paragraph 126 of the Proposed Standard, we agree that a restatement of previously issued financial statements is a strong indicator of a material weakness, but suggest the Board provide guidance regarding how to treat a material weakness identified in a subsequent period yet pertaining to a prior period. For example, it appears that if a financial statement restatement occurs, there is a strong indicator of a material weakness in the period that is restated, but not necessarily as of the latest balance sheet date.

- With regard to the fourth bullet point in paragraph 126, we believe that an ineffective internal audit function has implications for all entities that support such a function. In addition, this bullet point infers that all larger, more complex entities should support an internal audit function, effectively mandating the same for such entities. We recommend the Board clarify its intentions with regard to the application of this provision to larger entities that do not support an internal audit function and smaller entities that support an internal audit function that is found to be ineffective.

- With regard to the fifth bullet point in paragraph 126, we believe further clarification of the auditor's responsibility with regard to the entity's regulatory compliance function is necessary in order to effectively interpret the scope of this provision. In other words, is the auditor responsible for evaluating the effectiveness of the entity's controls that do not have a direct impact on the entity's financial statements and disclosures? Many entities operating in highly regulated industries maintain extensive regulatory compliance functions addressing, for example, product development, environmental matters, workplace safety, and employment opportunities. Many of the activities of these compliance functions do not directly impact the entity's financial statements and disclosures.

  We note that paragraph 14 of the Proposed Standard refers to "…operations and compliance with laws and regulations directly related to the presentation of and required disclosures in financial statements" as being encompassed in ICOFR. We recommend the Board clarify in the final standard that the reference to an entity's regulatory compliance function in paragraph 126 is consistent with the notion of compliance activities directly related to the presentation of and required disclosures in financial statements addressed in paragraph 14 of the Proposed Standard.

- With regard to the sixth bullet point in paragraph 126, it appears that the Proposed Standard establishes an obligation on the part of the auditor to determine whether senior management has been party to any fraud. AU Section 317.08 indicates that, "Normally, an audit in accordance with generally accepted auditing standards does not include audit procedures specifically designed to detect illegal acts". However, instances of management fraud that come to the auditor's attention may require some action on the part of the auditor.

We believe that the auditor should consider compliance with laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts. In addition, the auditor should be aware of compliance matters that may have a material, but indirect, effect on the entity's financial statements. If the auditor becomes aware of compliance matters that could have a material, indirect effect on financial statements, action on the part of the auditor should be required. We recommend that the Board consider revising the sixth bullet point in paragraph 126 to clarify that the auditor is responsible for considering those illegal acts that may be significant to the entity's financial reporting process.

- We believe that instances of an ineffective control environment should be considered at least a significant deficiency, and a strong indicator of a material weakness, in ICOFR.

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?

We believe that the auditor's consideration of the effectiveness of the audit committee's oversight of the entity's external reporting and ICOFR is contemplated in his or her responsibility to obtain an understanding of and test the design and operating effectiveness of controls related to the control environment in its entirety. In addition, we believe that an effective audit committee plays a significant role in setting a positive "tone at the top." However, we do not believe that the auditor should be required to separately conclude on the effectiveness of the audit committee's oversight.

Ultimately, we believe that an entity's board of directors, not its independent auditor, is responsible to evaluate the effectiveness of the audit committee's oversight of the entity's external financial reporting process and ICOFR.

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

We believe that an auditor's ability to effectively evaluate the effectiveness of the audit committee's oversight is negatively affected by a number of factors. Auditors generally do not have unfettered access to audit committee members, may not attend all audit committee meetings, and do not have access to all information considered by audit committee members in the performance of their stated duties.

In addition, it is not clear to us how the auditor determines how well the audit committee understands its responsibilities, the amount of time that the audit committee devotes to control issues or the amount of time audit committee members are able to devote to committee activity. Further, the determination of whether the audit committee complies with the applicable listing standards adopted pursuant to Section 301 of Sarbanes-Oxley and includes one or more financial experts as described in the SEC's rule implementing Section 407 of Sarbanes-Oxley appear to be matters of legal interpretation and regulatory compliance that generally fall outside the scope of reliable financial reporting.

If this requirement is retained in the final standard, we recommend that:

- The criteria referenced in the auditor's evaluation be clarified to facilitate consistent application;
- Management be required to evidence its evaluation of the audit committee as part of its assessment of ICOFR; and
- The auditor be required to obtain written representation from the audit committee as evidence in performing his or her evaluation.

Refusal by an audit committee to furnish the aforementioned written representation should constitute a scope limitation.

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. We do not believe that resignation by the auditor necessarily serves the public interest. In addition, we do not believe that an auditing standard should dictate client retention conclusions to the auditor. While an auditor may decide to withdraw from an audit engagement in these instances, such decision is a professional matter for the auditor to consider based on available facts and circumstances.

Questions regarding forming an opinion and reporting:

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?

Yes. We believe that, by definition, identification of a material weakness in ICOFR should result in the auditor expressing an adverse opinion. The SEC final rule implementing the provisions of Section 404 of Sarbanes-Oxley states that, "Management is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting." We believe that the SEC's rule implementing the provisions of Section 404 requires management, upon determining the existence of a material weakness, to conclude and report that the entity's ICOFR is not operating effectively. Accordingly, we believe that the auditor's reporting should be consistent with the required reporting model for management.

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

As illustrated in example A-3 in the Proposed Statement, we believe that examples of scope limitations beyond management's control may exist where the auditor's issuance of a qualified "except for" conclusion is an appropriate alternative. However, as noted in the response to question 25 above, we do not believe that a qualified "except for" conclusion is appropriate in those instances where a material weakness exists.

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?

Yes. Further, in order to definitively conclude on the engagement scope contemplated by the Proposed Standard and eliminate potential confusion regarding the meaning of "management's assessment" as referred to in the auditors' report, we recommend that the Board consider requiring that the auditors' report speak directly to the effectiveness of internal control over financial reporting. We believe that, despite the clarifications as to scope included in the Proposed Standard, continued use of the "management's assessment" terminology in the auditors' report serves to detract from a consistent understanding of the scope of an audit of ICOFR.

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?

No. We believe that the SEC rules on independence are sufficiently comprehensive. Additionally, we do not believe that the Proposed Standard is the appropriate forum for providing guidance on independence and internal control related non-audit services.

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

We believe that the independence matters relating to the provision of non-audit services by an entity's independent auditor are sufficiently addressed in the aforementioned SEC rules. We do not believe that additional guidance in this area is necessary at this time.

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?

We do not believe the auditor has, or should have, a different level of responsibility in reference to management's disclosures responsive to the requirements of the quarterly and annual certifications, other than as outlined in the Interim Standards. We believe that existing guidance outlined in the Interim Standards addressing the auditor's responsibility for other information in documents containing audited financial statements (AU Section 550) or interim financial information (AU Section 722), and illegal acts by clients (AU Section 317), is sufficiently comprehensive and well understood in practice.

Clearly, an auditor's responsibility in the conduct of a review of interim financial information is different from that in an audit of financial statements or ICOFR. AU Section 550, the provisions of which also apply to reviews of interim financial information pursuant to AU Section 722, states that, "The auditor's responsibility with respect to information in a document does not extend beyond the financial information identified in his report, and the auditor has no obligation to perform any procedures to corroborate other information contained in a document. However, he should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation appearing in the financial statements."

AU Section 317, also referenced in AU Section 722, addresses the auditor's consideration of the possibility of illegal acts and the auditor's response to detected illegal acts. Accordingly, we believe that those instances where an auditor encounters inaccurate or omitted disclosures by management are clearly and sufficiently addressed in the Board's Interim Standards, and further analysis is unnecessarily duplicative in a final standard on auditing ICOFR.

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

We do not believe the auditor's responsibilities relative to management's quarterly disclosures regarding ICOFR should go beyond those outlined in AU Sections 722, 550 and 317 (including Section 10A of the Securities Exchange Act of 1934). In fulfilling this responsibility, we believe that it is appropriate for the auditor to perform, on a quarterly basis, the procedures outlined in paragraph 186 of the Proposed Standard. See response to Question 30 above.

* * * * * *

If you have questions regarding the information included in this letter, please contact Sam Ranzilla, (212) 909-5837, sranzilla@kpmg.com or Craig W. Crawford, (212) 909-5536, ccrawford@kpmg.com.

Very truly yours,

KPMG LLP

The following editorial and other comments and suggestions are presented for your consideration:

1. Paragraph 8 – the definition of significant deficiency includes "interim financial statements." As the Proposed Standard provides for an "as of" date audit, which is generally assumed to be the audited balance sheet date, clarification should be provided regarding the inclusion of the term "interim financial statements" and the related implications for test work and reporting.

2. In paragraph 33, the auditor can provide certain permissible internal control-related services if *specifically* pre-approved by the audit committee. On the surface, this requirement appears to be a modification of the SEC's rules relative to pre-approval of auditor services included in the SEC's final rules on independence (Release No. 33-8183). In order for audit committees to understand their obligations regarding pre-approval of auditor services, we believe that the SEC should provide similar guidance in the securities laws governing audit committee pre-approval requirements.

3. Paragraph 61 - the definition of a significant account appears too broad. Literally, all accounts, when aggregated with other accounts, could contain more than a remote likelihood of a significant misstatement. We encourage the Board to clarify the intent of this paragraph in the final standard.

4. Paragraph 82 infers that walkthroughs of transactions both before and after a significant change in the process flow of transactions may be necessary in some circumstances. We believe that this concept is confusing in light of the auditor's requirement to report on ICOFR as of the audited balance sheet date. We suggest that this paragraph be deleted from the final standard.

5. In paragraph 102, the term "high level of assurance" is used (this term also is used elsewhere in the document). The use of different terms to refer to the concept of "reasonable assurance" is confusing. We believe that the term "reasonable assurance" should be used in those instances where the auditor's level of assurance is referenced.

6. In paragraph 126, the existence of significant deficiencies that have been communicated to management and the audit committee and remain uncorrected after some reasonable period of time is considered a strong indicator of a material weakness. We believe the Board should consider defining a "reasonable period" in the final standard as no later than the entity's next "as of" reporting date.

7. Paragraph 145 states that, "the auditor should document the identification of where misstatements related to relevant financial statement assertions could occur within significant accounts, assertions, and processes." The term "where" generally refers to a location. We recommend that the term "how" be used in place of the term "where" in the final standard.

8. Paragraphs 146 and 147 appear to be out of place in the Proposed Standard. We suggest that information included in these two paragraphs be reflected in a section addressing the interaction of the audit of ICOFR and the financial statement audit.

9. In paragraph 179, we believe that the term “how” should be used in place of the term “why” in the final standard.

10. Paragraph 189 refers to an auditor’s reporting obligation in instances when the “…auditor believes management’s certifications should be modified.” The term “certification” should be replaced with the term “disclosure” to appropriately describe the auditor’s responsibility in these instances. Refer to responses to Questions 30 and 31.

11. Paragraph 194 should be revised to clarify that the final standard also will apply to audits of financial statements of entities other than accelerated filers for years ending on or after April 15, 2005. This paragraph currently appears to refer only to the auditor’s obligation for audits of ICOFR for accelerated filers.

12. The footnote to example A-3 should note that, in the event the auditor identifies a material weakness that is not included in management’s assessment, the auditor expresses an adverse opinion on the entity’s ICOFR.

13. All example reports in Appendix A should be revised to include reference to City and State above the date line. In addition, these example reports should indicate by footnote that the ICOFR audit report date should be the same as the financial statement audit report date.

* * * * * *

I appreciate the time and effort invested in this proposed Auditing Standard (AS) by the Public Company Accounting Oversight Board (Board) and the opportunity to comment thereon. I, as many others who have commented on the proposed AS, am deeply involved in ensuring my company's compliance with SOA Section 404. Therefore, I am compelled to write to you my concerns with the proposed AS.

For the most part I agree with the Board's recommendations. However, I find that there are key weaknesses in the proposal as currently written that will not only have a significant negative impact on businesses, but they also are contrary to the intent of SOA.

I concur with the summary of the weaknesses as presented by the Manufactures Alliance/MAPI dated November 21, 2003. In addition to the comments made by MAPI I want to express emphasis on the following point:

1. External auditor's opinion on management's assertion vs. an opinion on internal controls. The SOA very clearly states "(b) Internal Control Evaluation and Reporting – with respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by management of the issuer." The limited amount of assurance the Board is allowing auditors to place on management's testing is contrary to the wording chosen by Congress. There is ample professional literature and time tested experience that give guidance and methods to direct auditors on how to rely upon or what not to rely upon in coming to a conclusion identical to a conclusion that would be drawn by re-performing essentially the same work. The extent of work being required by the Board is closer to the auditor being able to offer an opinion on the effectiveness of the controls rather than "management's assessment". This is a costly distinction that adds minimal, if any, additional value to shareholders. In essence, the Board is requiring management and the external auditors to do the same work. Before I leave this topic I also think it important to mention this goes against the intent of COSO. COSO specifically states that management owns the controls and is responsible for their design and continued maintenance. Once management effectively implements processes consistent with COSO they will have in place "monitoring" that ensures controls over accurate financial statements are in place and functioning as designed. Based on the Boards proposal, the external auditors in addition to management will be responsible for performing the "monitoring" portion of COSO instead of offering an opinion on management effectively or ineffectively performing its own "monitoring".

   I ask that the Board not lose sight of the objective of SOA which is to give investors confidence as to a companies internal controls over financial reporting and disclosures. That being the objective, I do not see where having two groups perform the same work gives investors additional confidence. When the auditor performs their audit in accordance with the current standards for relying upon managements' work, they can gain essentially the same assurance as to the adequacy of the controls as they would by re-performing the same work. Another relevant consideration is, would the Board's proposal as written have detected the problems at Enron, HealthSouth, et al, with any more certainty than the auditor's attestation of management's assertion as discussed above? I think the answer is no.

From: richardlee@ixna.com
Sent: Wednesday, November 05, 2003 4:05 PM
To: Comments
Subject: PCAOB Rulemaking Docket Matter No. 008

Public Company Accounting Oversight Board
Attention: Office of the Secretary
1666 K Street, NW
Washington, DC 20006-2803

SUBJECT: PCAOB Rulemaking Docket Matter No. 008

Via email: comments@PCAOB.org

Dear PCAOB Commissioners,

Both the PCAOB and the SEC should be commended on the comprehensive and rigorous efforts since the passage of the Sarbanes-Oxley Act to implement new rules and regulations to help rein in the abuse and greed that threatens Corporate America. Your approach thus far has been balanced and fair.

The subject of internal controls is an interesting one that unfortunately is probably not well understood by most investors. It is a topic that has not received an appropriate amount of attention over the past few years and one that is actually not as complex as some may make it appear.

Unfortunately, internal auditors and external auditors have made internal controls more complicated by engaging in a practice of "documenting controls" that provide very little value, meaning, or relevancy to the day-to-day operations or financial statement reporting integrity of an organization. They have done this because they needed to teach inexperienced staff members how to cost-effectively discharge their duties of evaluating a business process of which they have actually very little knowledge or comprehension. This effort to document controls served as an easy way out for the auditors. It ignores the need to assess risk and apply critical judgment to increasingly complex business processes.

Forgetting independence issues for a moment:

- Enron spent millions of dollars outsourcing internal audit work to Andersen,
- Tyco spent millions outsourcing internal audit work to PWC.
- Healthsouth spent millions outsourcing internal audit work to Ernst & Young.
- Adelphia spent millions outsourcing internal audit work to D&T.
- Levi Straus spent millions of dollars outsourcing internal audit work to KPMG

And what did they do? They exhaustively documented the existence of internal controls within critical business processes of which they had limited understanding. They deployed inexperienced, often straight out of college, staff members without adequate training or supervision to interview business process owners and to document the existence of controls. They tried to standardize complex business processes into forms and checklists that could be "leveraged" to staff apprentices. The economic needs to take this pressure are enormous. Staff members generated on average over $175,000 a year in revenue and are paid but a fraction of what they produce. The economic model that each of the big-four firms is similar. Inexperienced staffs do the majority of the work and produce the majority of the revenue. Meanwhile partners and other "experienced" professionals are engaged to sell the work.

For the past twenty years or more the public accounting profession has aggressively strayed from their roots of providing independent, objective, audit opinions on financial reports to pursue lucrative consulting, tax, and internal audit related services. They traded their integrity and trust for growth and profits. They let down the shareholders and board members who hired them as they succumbed to management's financial incentives.

In order to ensure the effectiveness of internal controls within a company the PCAOB needs to listen carefully to management and stockholders and not to the public accounting professionals who claim to be experts at internal control systems when they have recklessly managed an effective understanding of internal controls for the past twenty years. The purveyors of accounting solutions are motivated by a simple desire to enrich their private partnerships with wealth at the expense of Corporate America.

Business owners, managers and stockholders on the other hand have a vested interest in achieving sound systems of internal control. In a competitive business environment they need to have sound internal control systems in order to remain profitable and to attract capital investment for their endeavors.

Companies not only own and manage these systems, but they also work hard to design, improve, and enhance internal controls. Through this process individuals throughout an organization, not just in internal auditor, develop experience and knowledge critical to assessing and evaluating the effectiveness of internal controls.

In order to comply with the requirements of Section 404 management must be able to rely on both their internal auditors ability to help assess the internal control environment and the abilities of individuals throughout their organization in executing their responsibilities to maintain the internal control system within the organization. Therefore, in paragraph 108 of the proposed standard, the Board should specifically recognize the fact that: employees throughout an organization performing their daily activities and tasks are an integral part of the system of internal controls and that these individuals represent a valuable resource that organizations could and should call upon as they attempt to document, evaluate, and otherwise understand the existence of internal controls.

Paragraph 108 appears to limit an auditors ability to rely upon the work of others when clearly there are and should be instances when this is
desirable. A professional and well-managed internal audit function is
important but restricting an Auditor from relying upon work performed by other "non-internal audit" employees in documenting or testing internal controls may have other negative consequences that should be considered.

For example, Audit firms may suggest to management and the audit committee that the internal audit resources available to staff these engagements are not sufficient and therefore they, the external auditors, need to provide resources to "assist management in documenting internal controls." This scenario has already manifested itself in the marketplace as numerous companies have already engaged their independent auditors to "assist in the documentation of internal controls." The problem with this is that not only does it have the undesirable effect of compromising the auditor's independence, as discussed further below, but also it effectively provides the auditor with a license to violate other principles of independence.

Despite the SEC's own rules on Auditor Independence, current business practices clearly would suggest that the Big Four accounting firms are actively engaged in disguising non-audit related activities and more detailed control-related activities as permissible activities by billing them as part of the "documentation of internal controls for Sarbanes compliance. This is occurring at an account level throughout the country at numerous companies. Some firms are actively assisting clients in remediation of their internal controls around IT Systems, the Financial Statement Close Process, or other key business processes as part of the services that they cleverly call "audit related" or "documentation related."

Audit Committees are being duped by their auditors and management as they believe they are buying one service when in fact the auditors are performing special projects for management that are only remotely related to the documentation of internal controls. In the current environment they (Audit Committees) should not be surprised to see that the nature of work performed varies significantly from what was presented to them in an audit committee meeting or represented to them in a letter of understanding by their external auditors. Audit Committees would be well advised to evaluate the actual work performed and scope of services for all projects they authorize that are not part of the financial audit and to possibly carefully scrutinize the scope of services now being billed as part of the financial audit.

The PCAOB should clearly articulate that public accounting firms cannot and should not be engaged to "assist audit clients in designing, implementing, assessing, or evaluating internal controls as a separate engagement independent of the financial audit." Performing these services in conjunction with a financial audit and an attestation of management's assertions on internal control should be permissible. But any other independent activity or engagement that is designed to assist a client in assessing or evaluating their internal control system should be specifically prohibited. Auditors should be placed on notice that internal controls is the responsibility of management and they should not act as special advisors on such topics except at a de minimis level.

Several of the large accounting firms have been engaged in providing their client's with templates or software packages that enable companies to document and evaluate internal controls. Because of the potential for perceived conflicts many of these transactions have been performed through intermediaries or third parties. For instance, one major accounting firm has an agreement (possibly as a verbal amendment to an existing contract or otherwise) whereby they are entitled to certain discounts and incentives when they refer business to the software vendor. Another firm helped develop a conceptual architecture for other software vendors to employ. The resulting software products are now promoted to their audit and non-audit clients as Sarbanes-Oxley solutions.

Understanding the financial dealings or agreements behind these relationships is not a matter of public record – but it certainly raises significant questions as to what incentives exist for these firms to promote software products to their clients. Even if there is no remuneration, or other direct incentives, the public auditors objectivity will ultimately be compromised when they are called to attest to management's assertions on internal controls. Consider if you will a situation whereby a client spends $250,000 with one of the "recommended providers" of software to assist in the documentation process. If the software doesn't do the job it was intended to do and the auditors recommended and promoted the solution or otherwise helped design the system, are they going to be objective in questioning management's evaluation of internal controls? Are they going to point out deficiencies in the client's new system? Probably not!

This raises another important point. Regardless of the fact that Auditors may be engaged in the practice of disguising inappropriate non-audit services as part of the "documentation of internal controls" effort, Auditors should not be engaged to assist in the documentation of internal controls. The proposed rule states in Paragraph 19:

For the auditor to satisfactorily complete an audit of internal control over financial reporting, management must do the following: ……C) Support its evaluation with sufficient evidence, including documentation, and…."

Paragraph 43 specifically outlines what an auditor might have to do to determine whether management's documentation provides reasonable assurance to support their assessment on internal controls. The Board appropriately defined some factors that the auditor should evaluate in assessing the quality of the documentation in supporting management's assertions. Since the Auditor is attesting to these assertions it seems to reason they should play a very limited and restricted role in devising any component that would be the subject on which management based their own evaluation and assessment.

Surely the auditor should not be engaged to assist the company in performing this documentation. Doing so, places the auditor in a position whereby they would have to assess the adequacy of internal documentation that they helped create. The result clearly places the auditor in a position of "auditing their own work." It also impairs their ability to provide impartial judgments on the quality of the documentation.

The rules are very clear on this point. In fact Grant Thornton, the fifth largest public accounting firm, arrived at this same conclusion and issued a press release on September 2nd 2003 stating that they would not provide services to document internal controls to their public audit clients. Meanwhile the Big Four firms have been deafly silent on this issue as they continue to deploy resources to their public audit clients to perform this and other non-audit related activities.

The existing rules seem to clearly prohibit this type of behavior; nevertheless the facts speak for themselves. The motivation of the Big Four to protect this will undoubtedly be disguised in their responses in the commentaries that will follow. A quick review of recent press releases forecasting record revenue for public accounting firms in fiscal year 2004 underscores the real motivation behind their complacency on these issues. In fact, the SEC and PCAOB should issue an immediate order clarifying this point otherwise the firms will continue to book revenue and claim ignorance of the blatant facts that Grant Thornton has clearly identified in their own reading of the rules.

Thank you for considering these comments to your important standard setting process. Some of the items brought forth point to larger issues of reform and/or are matters that may require further investigation on the part of the PCAOB. Ultimately, true reform will come when the large public accounting firms start to play by the rules that you have proposed and stop trying to find profitable loopholes whereby they can capitalize on the fear, uncertainty and doubt upon which they currently prey.

Richard Lee
1783 Nassau Hall
Princeton, New Jersey 08544

November 21, 2003

Mr. Thomas Ray
Deputy Chief Auditor
Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

Reference: PCAOB Rulemaking Docket Matter No. 008

Dear Mr. Ray:

We are pleased to submit this comment letter to the Public Company Accounting Oversight Board (PCAOB) in response to the PCAOB's request for comments regarding the proposed auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*, Release No. 2003-017. Our comments pertain to the financial reporting by Lincoln National Corporation, (LNC), that relates to life reinsurance operations that LNC has disposed of by transferring the business to an unrelated reinsurance company under indemnity reinsurance agreements.

LNC is a Fortune 500 financial services company providing life insurance, annuities, qualified retirement plans, and investment management products to retail and institution clients. In 2001, LNC disposed of its life reinsurance business by transferring the business to Swiss Re. The disposition was accomplished by a combination of sales of certain stock subsidiaries that had been wholly engaged in the reinsurance business and indemnity reinsurance transfers. Because a primary LNC subsidiary insurance company formerly engaged in the reinsurance business also conducts ongoing direct life insurance and annuity businesses, the indemnity reinsurance agreements were necessary for LNC to completely exit the life reinsurance business. In exiting these lines of business, LNC also entered into administration agreements with Swiss Re under which the administration and accounting for the business has been transferred to Swiss Re. Accordingly, LNC no longer manages or maintains the accounting records of the exited reinsurance business.

An indemnity reinsurance transfer, combined with an administrative services agreement, is typically used within the life insurance industry by companies that are completely exiting selected lines of business, while retaining other lines of business.

An alternative structure would be an assumption reinsurance transfer, which results in a complete release of the selling company from all legal liability associated with the underlying insurance business. However, obtaining the regulatory and policyholder consents required in an assumption reinsurance transfer is a very time-consuming, costly, and uncertain endeavor. For these reasons, dispositions of entire lines of business within the life insurance industry are often structured as indemnity reinsurance transfers.

Since the selling company is not relieved of its legal obligation with respect to the underlying insurance policies in an indemnity reinsurance transfer, FAS 113 requires the seller to retain the policyholder liabilities on its balance sheet along with an offsetting recoverable from the acquiring reinsurance company. Because the acquiring company obtains all rights and obligations relating to the underlying transferred business, the ongoing FAS 113 accounting associated with the life reinsurance business will have no net impact on selling company's financial statements. At the same time, by reflecting both the policyholder liabilities and an offsetting recoverable from the acquiring company on its balance sheet, the selling company's ongoing credit exposure to the acquiring company is reflected on the face of the selling company's balance sheet.

In addition to reflecting the policyholder liabilities and the recoverable from the acquiring company on its financial statements, FAS 113 also requires that the selling company defer the gain associated with the indemnity reinsurance disposition. The selling company must amortize this deferred gain into net income over the estimated life of the underlying business.

Since the selling company does not maintain or administer the life reinsurance business due to the sale and the corresponding transfer of administrative responsibilities, the selling company's financial reporting control processes related to the exited business are typically focused on the following matters: (a) the accurate accumulation of financial information supplied by the acquiring company, (b) reviewing the financial information for reasonableness, (c) reporting this information in the selling company's financial statements, and (d) properly accounting for the selling company's FAS 113 deferred gain. In addition, on an ongoing basis the selling company will monitor and evaluate the credit worthiness of the acquiring company.

Under these circumstances, the design and the operation of the policies and procedures related to internal controls over the financial reporting associated with the exited lines of business are not the responsibility of the selling company. The administrative efforts and costs that would be incurred by the selling company to document and test the acquiring company's controls over financial reporting, as it relates to the information provided to the selling company for the exited lines of business, would not produce any meaningful benefit to the selling company or to the users of the selling company's financial statements. Once again, this is because there simply is no net impact on the selling company's financial statements related to the exited business.

Support for this view can be derived from the general concepts included within Appendix B of PCAOB Release No. 2003-017, at paragraph B16 and footnote 1 which provide that some accounts can be excluded from the documenting and testing of controls when the company does not have sufficient control or responsibility with respect to those accounts. In addition, paragraphs B18 and B19 provide some relevant guidance under the topic of *Identifying Significant Accounts*.

To clarify this matter, we request that the PCAOB issue explicit guidance providing that LNC, and other similarly situated life insurers, should not be required to document and test the internal controls of the acquiring company related to the reporting of financial information on exited lines of business that have been transferred under indemnity reinsurance agreements.

Thank you for the opportunity to comment on this proposed auditing standard. If questions arise, or additional discussion on this topic is desired, please contact me at 215 448-1408.

Very truly yours,

Casey J Trumble
Senior Vice President, Tax & Reporting

From: William Livingston [vitalith@earthlink.net]
Sent: Friday, November 21, 2003 7:33 AM
To: Comments
Subject: PCAOB rulemaking docket matter No. 008

Office of the Secretary:

In your PCAOB Release No. 2003-017, October 7, 2003, you proposed an Auditing Standard governing attestation engagements, referred to in the Sarbannes-Oxley Act of 2002, and requested comments from interested persons. I am a registered professional engineer (PE) and a member of The Institute of Internal Auditors (IIA). There is keen interest in the official response aimed to "deter" the process by which The Class of Enron managed to implode our 401K retirement accounts while so very many professional and fiduciary watchdogs were on duty. The trillion$ are long gone: the watchdogs remain employed.

Representation
The comments herein originate exclusively from the professional practice of engineering, without condition or disclaimer, representing the profession's standard of care and conditions of the PE license. These functional perspectives are independent of any official position of the IIA and do not represent any IIA views concerning your release. The material differences in the frameworks of professional practice between engineering and internal auditing (a primary basis of your proposed standard) structure this commentary. The assessment work was paced by the Attribute and Performance Standards (IIA Professional Practices Framework 09/03) and IIA Practice Advisories for an attest engagement regarding PCAOB assertions. The assessment had to stop short of the level of detail questions listed in your release after determining an overriding mismatch of methodology to purpose.

The Professional Engineering benchmark
The profession of engineering operates to a venerable code of conduct, little changed in the last century, with significant obligations to society unlike those demanded of any other licensed profession, including law, accounting and internal control. The professional engineer is duty bound to hold the public health, safety and welfare paramount. In the rules of action to meet this responsibility, the professional engineer is required to detect incipient program misalignment with the stated objectives and warn the designated authorities "up the ladder." The reliable determination of impending (future) failure to meet the schedule, budget and results specification obliges the PE, upon completing warning duty, to withdraw from the project. The proactive duty of the PE is focused on prevention and avoidance, not confined to reacting to the events of damage. The very presence of a professional engineer on a project is taken as assurance of a successful goal-seeking enterprise.

Since no excuses are permitted, failure to deliver on the pledge of damage preemption is not an option. The fact of damage itself is sufficient to establish dereliction of duty. The professional engineer, grounded in the myriad laws of nature and trained to leverage them to good purpose, cannot blame failure on the moral or ethical shortcomings of others. There is no "inherent limitations" escape hatch out of the pledge to public welfare - and for good reason.

The no-excuses, no-escape mandate, oblivious to the ethical makeup of the participants, has long been accepted by the engineering profession because, simply, there is no other viable way in the rule of law to preserve society. We live in a world that is designed. The context within which society functions is largely composed of engineering artifacts - the material proceeds from the process of engineering. Who but the designers could rationally take the blame for the consequences of design? The mandate issue resolves thereby entirely to the extreme intellectual demand, necessary and sufficient, to select action appropriately in mind-numbing complexity.

The Orders of Magnitude guideline
Set one (1) as the value of the intellectual investment necessary to "experience" an engineering artifact, such as riding as a passenger in a car. Judgments are made in the experiencer situation by individual instincts and feelings. The successful "operator " of the car must invest at least ten (10) intellectual units to be a provider of the dynamic automobile experience (1). The successful "maintainer" of the car must invest an order of magnitude more (100) in knowledge acquisition than the operator (10) about the systems comprising the car and their interaction dynamics in order to diagnosis, repair and restore operational functionality of the vehicle. The car

"designer" engineers must each make an intellectual investment of at least a thousand units (1000), an order of magnitude greater than the maintainer (100). The scope and depth of knowledge necessary to appropriately select that which will comprise an automobile satisfactory for its market in future time is daunting. Shannon's tenth theorem allows no wormhole for professional judgment to reduce the quantity of knowledge necessary for appropriate selection to take place.

Internal auditing is subject to the same scaling factors. The designer of the internal control system must possess far more knowledge than its operators. This demand is emphasized several places in the PCAOB standard. If the auditor of internal control is to serve as benchmark and design basis for meaningful tests and walkthroughs, for example, he can know no less than the designers of the system. Conclusions of the attestation require the support of reason. In practice, this is more than a formidable task. Until the requisite knowledge is developed and organized, the lists of criteria to apply to it must remain dormant.

Complexity Management
The process of engineering is a systematic assault on complexity - completely, rigorously and scrutably connected to natural law. Engineering design is dealing with the future in knowledgeable anticipation of the dynamics that produce both benefits and consequences. Since damage avoidance is a central concern in the process of design, the intellectual demand for damage preemption is at least three orders of magnitude higher than that for damage response. The enormous differences in task complexity between responding to damage and preempting it require different methods. Since the frame of reference for the comments, required for professional engineers, must be prevention, avoidance and preemption, there is an inherent conflict with the basis for all rules of action, the essence of regulatory agency - damage response. Nothing in the realm of damage response translates forward to the duty of damage avoidance. It is essential to recognize the incompatibility between the activity package commensurate to the line of time past (analysis) and those activities of synthesis effective with deciphering the expanding cone of the future, which is, exactly, the only place where goals are attained and ethics assigned.

The social controls context
The distinction between prevent and remedy values, between analysis and synthesis, is vividly reflected in the striking difference between how society rewards and honors the heroes who rise to the crisis occasion and how it ruthlessly punishes the preemptive whistleblower. The corporate budget, along with this PCAOB standard, clearly reveals the full allocation of resources to damage response at the expense of damage prevention. Cultural bias in resource allocation, favoring damage response, is the gateway for fraud.

The hostility to damage preemption is connected with society's instinctive loathing of the process of engineering. Regardless of society's addiction to engineered artifacts, the process of engineering and, by association, its practitioners, reside in the bilge of necessary evils. From ancient times to this day, the process of engineering (synthesis) has been considered a threat to social order with its despised practitioners, called nerds, mavericks and eggheads, to be obstructed, ridiculed and persecuted. No great encyclopedia, resplendent with the various specialties of science (analysis), by design, contains a section on engineering.

The long history of the struggle between the professional obligation to avoid damage and the extreme social prejudice for damage responding is fully captured and revealed in The Professional Practices Framework published by the IIA. The profession of internal auditing has sixty years of hard experience in the front lines of this fundamental conflict between incompatible method systems. There is nothing attempted or contemplated by the PCAOB in rule-based regulation that does not already have a rich precedent history in the IIA archives. While it is essential to accommodate the extreme cultural bias against preemption as a given, more viable avenues of influence have become available. The significant new workable factor impinging on the internal control affair is the great step increase in the capabilities of damage avoidance that has already occurred - through persecution, prejudice and all.

Significant note
While the march of science and technology has done little to alter the realm of rule-based operations (analysis), professional engineering owes you the duty of notification that the zone of effectiveness of the process of engineering (preemption) has, in the last few years, made a quantum leap far into the operational reality. The increase in complexity now within the scope of engineering design (synthesis), which is to say damage avoidance, is so large it has forever altered the working definition of key terms, such as "reasonable," in the legal and regulatory spheres. That which was computationally impossible in 1998 has already become routine engineering design practice. All the borders of the classical constraints to practical risk mitigation are being moved, ready or not, by advances in the process of engineering.

Whereas engineering methodology in use today was completely defined and scientifically validated by 1960, it took the relentless, exponential growth in computer power (Moore's Law) to successfully assault the quantities of complexities common to the systems of our daily experience. The process of engineering engages the extreme complexity of preemption through the use and control of intelligence amplification, an exact parallel to power amplification. Intelligence amplification (IA) is a three-step process by which the power of appropriate selection is increased significantly beyond the intelligence of the human operator who executes that process. One example of manifest IA is the cell phone. In operation, it consumes the equivalent intelligence of 80,000 coordinated "brains." Through IA, engineers are not limited in performance by the capacity of their own brain to process the information necessary for appropriate selection.

The market explosion in "intelligent machines" is directly proportional to the rate of growth in the basic competency to avoid damage. The two activities, design and preemption, are one and the same thing. For all practical purposes, today, there is nothing in the future of an engineered artifact that is not foreseeable (as in tort negligence) - in the context of practical and timely. In like manner, through the damage avoidance competency of the process of engineering, internal control need not be "subject to lapses in judgment and breakdowns resulting from human failures." There is no need to accept the "risk that material misstatements may not be prevented or detected on a timely basis ..." There are no inherent limitations.

For the purposes of the PCAOB, it is much more important to first recognize the inherent constraints in your basic approach to the SEC assignment as a prerequisite for "release" to detail. Like Pandora's Box, once released, you can't get the menace of unintended consequences back in.

The limits of regulation

The central law of nature that governs the performance of internal control is - control theory. This natural law ranks in significance with and combines seamlessly to the second law of thermodynamics. Control theory constrains the effectiveness of the rule-based regulatory process, as in the PCAOB, in fundamental ways. Managing operations by compliance to rules automatically eliminates the factors of mission objectives and process consequences in selecting task action. When activity choice is fixed by rules, loyalty is measured by obedience to the rules - and nothing else. When the context is appropriate for rule-based governance to be effective, it is also economically efficient.

The limits to the beneficial effects of rule-based governance are set by control theory - and nothing else. By its definition, a rule of action cannot call for replacing itself when events render it no longer producing satisfactory outcomes. If you design a rule that orders its own replacement when better goal-seeking activity emerges, you have not created a rule but a variety of engineering process. You can either specify the action to be taken, Aristotle's "efficient cause," or you can specify the results, goals and objectives to be attained, Aristotle's "formal and final cause." Control theory forbids specifying both simultaneously. You can choose to specify both, as you wish, but the effect that you cannot alter is to destabilize the proceedings and destroy productivity on all counts.

As a rule maker, the PCAOB cannot issue a rule which includes a responsibility, for those faithful in compliance with said rule of action, for any outcome aligned with your commission. Issue your rules, as you must. Enforce compliance, as you must. What you cannot do is transfer the functional responsibility for rule-compliant outcomes. When fraud evades the internal control system you designed, no big trick, the responsibility is yours. Oversight by hindsight is not kin to the insight of foresight.

Deaf to persuasion, control theory inserts an inflection point in the curve of productivity versus context for rule-based governance that does not exist for the process of engineering. When the context positively favors rule-based management, such as in a steady, repetitive business environment, as Henry Ford knew, more and better rules translates directly to more productivity. When the context turns toxic to governance based on rules of action, such as frequent intrusions of complexity and novelty, the inflection point will be breached. In mindlessly applying the same strategy when on the negative side of the inflection point, more rules immediately become grossly counterproductive. Because of this dramatic reversal in the sign of influence, it is the duty of every professional to be acutely aware of the point on this continuous curve occupied by his engagement. In practice, the determination of status of an engagement on the curve is simple and reliable. It is humanly impossible to mistake a situation on the positive side for one on the negative side. All red flags are flying vigorously in the same direction. To continue to apply standard procedure on the negative side of the inflection point, oblivious to the attending counterproductivity, is an error of principle.

Initialization requisites

The professional engineer, executing the process of engineering, must take two steps in initializing his engagement that are invariably omitted in rule-based practice. The very first task is to quantify the complexity entailed in the assignment. This is done by counting the number of relationships that comprise the field of knowledge from which appropriate selection must be made. It is the quantity of complexity, and nothing else, that determines which of the two possible strategies of control to apply to the assignment. When the field of ignorance is large, habitually and grossly underestimated, there is no alternative for the professional engineer but to engage intelligence amplification. The quantities of complexity grow exponentially with numbers of elements and relationships. In many cases of interacting systems, there is another exponent to the exponent. In the context of relatively small business organizations, the number of possible unique domain variations (the basis of appropriate selection) often exceeds the number of atoms in the universe.

The quantity of complexity residing in the engagement directly brackets the possible contribution of "professional judgment." Without doubt, when the quantity of engagement complexity is reasonably close to human capacities, professional judgment is a splendid, safe technique to improve productivity. Quite correctly, you require a reasonable basis for reliance - evidence - a rationale for forming an opinion, the trail of logic for assessment of design effectiveness. These assignments require knowledge development and, required by the Second Law, the imposition of coherent structure.

However, when the field of ignorance is very large and available information is error-laden, asking professional judgment to make a difference is, in effect, turning honest men into public liars. When the auditor is required to "understand how internal control over financial reporting is designed and operates to evaluate and test its effectiveness," and the quantity of complexity intrinsic to the system is sixty orders of magnitude higher that his intellectual capacity, it is the pursuit of the impossible. This affair falls under the absolute dominion of Ashby's Law of Requisite Variety - "Only variety can destroy variety." To legitimize an impossible auditor work context is bad news for stakeholders.

The second initialization step required of the professional engineer is to determine the "quality" of the information and data going into the business systems. There is no such functionality as "control" or "regulation" without incorporating the quality of the input data associated with the data itself as part of the computations. Any assumption of variable data as eternally "good" is professional malpractice. Recent published studies by the vendors of business software to support SEC compliance show that the data processed by organizations for compliance typically run between 10% and 30% defective. This finding is entirely consistent with the industrial process control experience involving physical instrumentation. It takes a great amount of diligence and focus to identify and label the quality of input data on a real-time basis for the purposes of dependable, robust control. The chore to systematically develop knowledge about the frequency, cause, impact and an appropriate response to data quality defects always pays off in prompt detection of serious system malfunctions. To bypass the labor of dealing objectively and thoroughly with information quality is a technical error with material consequences.

There are many more ways for data to be defective than to be good. Information can be missing, late, wrong units, wrong sign, mislabeled, out of plausible range, inaccurate, displaced, etc. Calculations that need to be synchronized, such as for periodic financial statements, present yet another dimension for errors. The requirement to address the information quality matter, as a tag that accompanies the data, is a prerequisite to the design of a control system that can deal with defective input information and, by diverse redundancy, still maintain satisfactory control up to a computable degree of quality degradation.

Displaced, misplaced supervisory control
The institutional response to the damage caused by the class of Enron includes a refocus of the responsibility for such damage in the future up the hierarchy to executive management. In the context where the quantity of complexity and its field of ignorance is huge, this direction is opposite to the supreme principles of control theory. Increasing the number of supervisory levels between the work face and the responsibility for workface results increases the time lag between creating the damage and responding to it. Increasing opportunity time for fiscal mischief elevates the risk of system instability, including scandal, litigation and bankruptcy. Fixing clear responsibility for the rule-augmented damage, in advance of its occurrence, may temporarily attenuate some stakeholder wrath, but this political expedient comes at the price of increased damage to the public. It is only a matter of time. The core issue remains unaddressed.

Avoiding the consequences
Damage preemption as delivered by the process of engineering is a byproduct of activity regulation at the workface. The time lag between error generation, taken as a given routine of the operational reality, and error detection, taken as a shared obligation of the work crew, is reduced towards zero. In the process of engineering, error at the work face appears as just another disturbance to goal-seeking activity to be compensated along with all the other disturbances, by knowledge-driven (designer grade) mid-course corrections. No problem. With every member of the workface crew an equal-opportunity preemptive whistleblower, the regulatory process involving

human diligence and compliance cannot be intentionally circumvented. In this workface crew context, fraud appears simply as yet another disturbance to be promptly remedied, rendering material fraud impossible. Intentions, morals and ethics of the workers are incidental attributes. No excuses.

When responsibility is administratively separated from the work face, the work crew standard of care forcibly locks in to brain-off, rule- compliance mode and the cause for damage preemption is lost. The disconnect and remote location of workface product responsibility is the reason you include "Inherent Limitations In Internal Control Over Financial Reporting."

Conclusion
In my professional judgment, readily validated by independent audit, rule-based regulation of internal control has already migrated well past the productivity/context inflection point and that both the regulators and the regulated are highly aware of that fact. Collectively, this aggregation of connected systems of control and regulation is deterministic. Given the status assessment described herein, any professional can confidently predict the future. These warnings satisfy the PE obligation.

The opportunity to provide commentary to the PCAOB in this convenient format is greatly appreciated.

William L. Livingston, PE

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LOCKHEED MARTIN

Rajeev Bhalla
Vice President and Controller

November 21, 2003

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

Sent via email to 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

Lockheed Martin Corporation welcomes the opportunity to provide comments on this proposed auditing standard, PCAOB Release No. 2003-017. Lockheed Martin is a publicly traded corporation principally engaged in the research, design, development, manufacture and integration of advanced technology systems, products and services. In 2002, we reported sales of $26.6 billion.

Before responding to the specific questions posed in the draft, we have some general comments.

We recognize and commend the Board for striving to balance the needs of its various constituencies in addressing this complex audit issue. We are concerned, however, that some provisions of the draft will still result in costs to companies well in excess of benefits to be achieved, both by the companies as well as the investor community. Specifically, the requirements for certain levels of external audit activity regardless of the quality and amount of management and internal audit effort—or for that matter the business, control, and ethical environments the company operates in—are troublesome. We feel this will result in excessive and duplicate testing—and cost—without corresponding benefit. In this instance, we believe the requirements confuse “audit activity” with “accomplishment of audit objectives.” Provision for auditor discretion should be made in this area.

Here are our comments concerning some of the specific questions raised in the draft:

Question 1—Attestation or Audit

We believe these terms are not interchangeable. We believe the language and intent of the Sarbanes-Oxley Act call for an attestation, not an audit. This proposed standard prescribes an audit.

Question 6—Scope of the Audit

We believe the scope of audit testing, and the amount of direct evidence to be gathered, should be determined by the auditor's judgment, taking into account the risks posed by the company's specific business and control environment, and the factors that can mitigate those risks. Intuitively, the controls of a company with a culture and demonstrable practice of integrity and "doing the right thing" should require less testing than the controls of a company with an aggressive, "push the envelope" culture and method of operation. The goal should be the achievement of audit (or attestation) objectives in an efficient manner.

Question 8—Inadequate Documentation

We do not believe inadequate documentation, regardless of context or effect, should be considered an internal control deficiency per se. Documentation may be a control, but it may also be merely one form of evidence of a control; there may be alternative evidence available. In the latter case, we do not see how inadequate or absent documentation could be construed to be an internal control deficiency.

Question 9—Walkthroughs

While we believe that walkthroughs have their place in the auditor's toolkit, we do not believe walkthroughs are practical or necessary in all cases. The auditor should be allowed to use judgment to determine the best method of achieving the audit objective.

Question 10—Requirement that only Auditor Performs Walkthroughs

As stated in our response to question 9 above, we believe there are instances where a walkthrough performed by the external auditor is not only unnecessary, but impractical. The auditor should be allowed to exercise judgment as to whether walkthroughs are required in all cases and, if required, whether a surrogate such as internal audit may be relied upon to perform the work.

Question 11—Annual Testing of All Relevant Systems versus Reliance on Prior Period Audit Work

We believe there are instances—for example, mature processes (no recent changes) involving minimal exercise of judgment performed by long-time employees who have proven to be competent and adequately trained—where the low level of risk could appropriately lead to reduced or periodic audit effort. We believe the audit standard should acknowledge this very real circumstance, and allow the auditor to exercise his or her judgment in this regard. If necessary, additional guidance could be developed to aid the auditor in making this judgment.

Question 12—Use of the Work of Management and Others

Depending on the degree of independence afforded the internal audit function by its charter, reporting relationship to management, and relationship with the Audit Committee of the Board of Directors, we believe the use of work performed by the internal audit function should not only be permitted but encouraged. In many cases, we do not see a meaningful difference in independence between an internal audit organization that reports to the Audit Committee, and an external auditor that is hired by and reports to the Audit Committee.

Among other things, we are concerned that demands made for work to be performed exclusively by the external auditors could potentially outstrip the capacity of the audit firms. This could lead to delays in performing the work, and likely would (given the law of supply and demand) result in significantly higher fees charged to companies and their shareholders. In our view, the ability of the external auditors to use the work of internal auditors and management, where appropriate, provides necessary elasticity to the supply of competent and experienced internal control testers and evaluators.

Question 13—Categories of Controls Defined

We agree with the categories of controls as defined, but disagree with the characterization of general IT controls in the draft. We do not understand, nor support, the position that work on the evaluation of general IT controls must be the exclusive realm of the external auditor.

Question 14—Role of Internal Audit

In our view, the draft does not sufficiently recognize and value the role of the internal auditor, nor does it acknowledge the distinction between internal audit and management. As mentioned above in our remarks under question 12, we believe there are more similarities between some internal audit organizations and the external auditor in terms of mission, training, and governance, than there are between those same internal audit organizations and management. The final standard should reflect this reality and expand the scope for acceptability of the work of those internal audit organizations, if necessary providing criteria by which the independence of the internal audit organization could be evaluated.

Question 15—Auditor Flexibility in Using the Work of Others

The auditor should be permitted to exercise his or her professional judgment in this area.

Question 17—Definitions of Significant Deficiencies and Material Weaknesses

We believe the definitions need further development and clarity, and need to be reconciled with each other and with the rest of the standard to eliminate inconsistencies and improve coherence. The mixture of established and well-understood terms of art, such as remote and material, with newer and less-well-defined terms, such as inconsequential, is particularly confusing.

We also believe that "inconsequential" (as we understand the use of the term) establishes a much lower threshold than appropriate for the purposes of this standard. We are concerned that this would result in a high volume of relatively minor issues that would need to be addressed (or at least debated), and that this would distract attention, resources, and focus from the more serious deficiencies.

We further believe that the well-established concept of compensating controls should be further acknowledged, and additional guidance provided on how it can be relied upon, in the final standard.

Question 20—Requirement for Auditor to Communicate All Deficiencies

We think the same principle should apply here as in a financial statement audit, namely that the auditor use his or her judgment to determine which findings are sufficiently significant to communicate to management.

Question 25—Adverse Opinion Due to a Material Weakness

Since management's representation is as of a point in time (December 31), the auditor's report should correspond to the same point in time. Therefore, an adverse opinion should only be required if a material weakness remains in effect at (has not been corrected by) the date on which management is reporting.

Question 27—Auditor Speaking Directly to Internal Controls in a Non-standard Opinion

We disagree with the position taken in the draft and the Board's explanation thereof. We also believe this position undercuts the Board's assertion that the auditor's examination of internal controls under this standard is necessary only in the context of evaluating management's assertion on the subject (see comments under questions 1 and 6 above). If the auditor's task is to evaluate management's assertion, let he or she do so. It is inconsistent and inappropriate to change the scope of the auditor's report based upon the audit conclusions.

If desired, we would be happy to provide more information about our reasoning. Thank you for considering our concerns during the Board's deliberations.

Sincerely,

/s/ Rajeev Bhalla
Vice President and Controller

Stephen Lucas
1584 Broadway
New York, New York, 10036

November 1st, 2003

Public Company Accounting Oversight Board
Attention: Office of the Secretary
1666 K Street, NW
Washington, DC 20006

SUBJECT: PCAOB Rulemaking Docket Matter No. 008

Dear Secretary & Other Distinguished Commissioners:

I have been following in the Wall Street Journal and other newspapers on the pending rules regarding internal controls. I have also paid close attention to the many accounting scandals of the past few years. I would like to offer my comments, as an individual investor, to your rulemaking process.

I am concerned because as I read through your rules I sense three major issues that are truly disturbing.

First, you are providing guidelines or rules for auditors to do their job. This is probably long overdue because as we all know they have not been doing their job lately and we have seen some very big audit failures. I commend you on this. But, it seems to me that many of the rules you are proposing are things that people like me would have already expected the auditors to be doing.

I would already expect auditors to look for fraud and to look at the client's financial reporting process to understand how it works. If they don't know that how on earth do they know whether or not the audits they are performing are sufficient? What were they doing?

It seems to me that if auditors were doing their job we would not have the problems we have today. I commend you on trying to establish rules that will make it clear that they can no longer put personal relationships with chummy former employees and customers who pay them to do "special projects" to look the other way. These abuses must be stopped.

Second, it seems that many companies are objecting to the impending rules because they are going to be cost prohibitive to implement. I've seen many articles that say the audits are going to cost more. Some estimate between 25% and 50% more. Well, if companies that are outside of the US do not have these same requirements then I agree with them - this is a bad idea because it makes US business less competitive in a global marketplace.

More importantly though, I must ask - why should audits cost more? Some articles seem to suggest it has to do with the fact that the auditors don't really make money performing audits. They use the audit as a "loss-leader" and instead make money doing all the other special things that got them into trouble in the first place.

Well that's ridiculous rhetoric. No business I know of continues to operate unprofitable businesses for very long. Judging from the expensive suits, lifestyles, and salaries that these Partners are living I seriously doubt they have been losing money in the audit business for very long. Instead I suspect that they are misleading us about how lucrative this business really is.

I recall reading an article earlier this year in the Wall Street Journal whereby the Chairman of one of these firms was making over $2,000,000 per year and was giving his ex-wife only $5,000 a month on which to raise there family. Apparently she had to sue to get the records of the partnership opened up so she could find out how much he really made. She not only had to fight her ex-husband, she had to fight the deep pockets of the firm to find out how much he was worth. The judge was so outraged that he awarded her over 60% of the marital property (which amounted to tens of millions of dollars).

It is obvious that he kept many secrets, including how much money he made and how much they were worth. He also had a willing accomplice - his firm in making his pleas of poverty. Are we to believe these people when they tell us they don't make money conducting audits? Another article suggested the average partner income is over $500,000/year. I am not sure if the article is right or not, but even if it was only half of that it seems to me they would be doing pretty well.

I don't believe for a minute that they do not make money on audits… that sounds like the hollow plea that the Chairman of that one firm gave his ex-wife when he offered her $1,000,000 to go away. We shouldn't believe it and we should recognize it for what it is - another attempt to deceive and mislead the American investor.

But the above story does give us some insight into the public accounting profession. It makes me wonder whether or not we can trust these people or whether they have become corrupt because of all of the money they do make.

Perhaps you should consider making these firms report their earnings publicly from each business line as part of the reforms you implement. Increased transparency for the public accounting profession would probably do more to create positive reform then anything else you could do. If nothing else it might cause more competition and drive down prices, thereby making the reforms you implement better for the companies I invest in. It's an interesting idea and one I think you should give special consideration to. It also would force them to not lie to us about how "unprofitable" audit work really is.

Third, and finally, when I read through your rules and some of the comments to date - I do not understand how the auditor can help their clients make sure their internal controls are good and then audit those internal controls. I may not fully understand the situation but it seems to me that what we are creating is a vicious cycle. Auditors help their clients document internal controls and presumably they get paid to do this - then they come in and audit the books and records and the internal controls and get paid again to do that?

It seems to me that someone cannot be independent when they help create the solution. It seems a lot like having the auditor also be the bookkeeper. If the auditor were to help his client set up the chart of accounts (help him identify how best to organize the accounts), instruct him on model formats on which to prepare the financial statements, and how best to collect the information they report in their financial statements and then audit those financial statements this would seem to me to be a conflict.

My impression is that companies should be responsible for that and the auditors should come in to make sure that the company did it right. It seems to me that this should be the same for internal controls. Companies should be responsible for that and the auditors (or perhaps some other independent body or other firm) should come in and tell them they are ok. Having them do both just doesn't make sense.

I appreciate you listening to my ideas and thoughts and thank you for your time and consideration. Hopefully your new rules will reign in some of the abuses that I see enable us to once again trust that the numbers we get from the companies we invest in are accurate.

Sincerely,

Stephen

Stephen Lucas

From: JCM [jcmahecha@yahoo.com]
Sent: Thursday, February 26, 2004 12:01 PM
To: Comments
Subject: PCAOB Rulemaking Docket Matter No. 008

I have read PCAOB Release No. 2003-017 and have some suggestions that may have already been communicated. Nevertheless, I hope my brief note may help. I do not represent any organization or company. My feedback is my own and is intended to express my opinion on a specific area of consideration to the "Proposed Auditing Standard-An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements".

Page 16 states that the proposed auditing standard requires the auditor to communicate in writing to the company's audit committee all significant deficiencies and material weaknesses the auditor is aware and report to management all internal control deficiencies in writing. Reliance on objectivity to determine what is significant and material is also noted.

Page 18 appropriately lists key questions 19 & 20:

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

20. Is it appropriate to require the auditor to communicate all internal control deficiencies (not just material weaknesses and deficiencies) to management in writing?

My opinion is that reliance on objectivity in relation to the severity of internal control weaknesses is a weakness in itself by affording auditors and management to "negotiate" the significance of such weaknesses and whether they need to be communicated and addressed. Therefore, ALL internal control over financial reporting weaknesses and deficiencies identified by the auditor, either directly or indirectly, need to be evaluated as to severity and communicated in writing not just to management but to the Audit Committee as well. Objectivity as to what is or is not significant should be determined by a combination of auditors, management and the audit committee.

Best regards,

JC Mahecha, CPA

Manufacturers Alliance/MAPI
Knowledge · Solutions · Results · 1933

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November 21, 2003

By E-mail (comments@pcaobus.org) and Federal Express

Mr. William J. McDonough
Chairman
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 008,
Release No. 2003-017, October 7, 2003

Dear Mr. Chairman and Members
and Staff of the Board:

PROPOSED PCAOB ATTESTATION ENGAGEMENT STANDARD:
An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements

Introduction

Manufacturers Alliance/MAPI Inc. (Alliance or MAPI) is pleased to have this opportunity to comment to the Public Company Accounting Oversight Board (PCAOB or Board) on PCAOB's proposed attestation engagement standard, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements." If adopted, the proposal would result in the standard on attestation engagements governing external auditor attest to management's assessment of internal control over financial reporting, as required by Sections 404(b) and 103(a)(2)(A) of the Sarbanes-Oxley Act of 2002 (SOA or Act).

The Alliance is a nonprofit business league, established 1933, in service to the business community under Internal Revenue Code Section 501(c)(6) for the purposes of engaging in economic and policy research and executive continuing professional education. Most Alliance members are public companies affected directly by SOA and subject to external audit by public company accountants (alternatively referred to herein as external auditors) registered with the Board. Consequently, the Alliance has a direct and immediate interest in the proposed standard to which this statement is directed.

To summarize, PCAOB's proposal is comprehensive, but also seems unnecessarily prescriptive and potentially quite costly for audited entities. In the broadest sense, the message we hope to convey to PCAOB in this brief commentary is one of "moderation" to the extent that the Board has discretion in carrying out this project while conforming fully to the spirit and intent of SOA Section 404. More specifically, we believe that the final standard should be more flexible, including some rebalancing with respect to the orientation to, manner of, and obligations for auditor testing of the control(s) subject to management assessment.

Having requested the first extension of the regulatory deadline for implementation of this provision and being familiar with the logistics of financial statement audit with this new appendage, the Alliance has no wish to delay this project. We understand the significance of Section 404, and are aware that the Securities and Exchange Commission (SEC or Commission) must review the final submission after PCAOB is finished with it. Meanwhile, the absence of implementation rules creates uncertainty for all parties and inconvenience—possibly including unnecessary cost—for companies, notably those in the early waves of affected parties having fiscal years beginning on or after June 15, 2004.

Background

SOA was enacted in circumstances of a "crisis of confidence" caused by accounting and audit failures at several public companies, which, in combination with economic conditions of recession, resulted in devastating equity market losses. In capsule summary, the Act was emergency legislation characterized by new rules of corporate governance and accountability and commensurately increased penalties for noncompliance.

As the most sweeping overhaul of the federal securities laws since the 1930s, SOA was intended to fill oversight and financial reporting gaps, address accounting and audit rule-making inadequacies, explore areas of suspected abuse, and sensitize all financial capital market participants to their responsibilities. At the same time, the outcome was intended to restore confidence in institutions and entities without prejudice to basic concepts of self-regulation and without detriment to the fundamental dynamism of private enterprises competing in open markets.

Since enactment of SOA, Section 404 has demanded considerable attention and resources of affected public companies to identify, map, and document all processes involving and internal control over financial reporting. The foregoing has been undertaken in anticipation of determining integrity of process that will support the required management assessment and independent attest thereto.

Although regard for internal control over financial reporting hardly is new in well-managed companies, the statutorily required management assessment subject to independent attestation adds a new dimension to the topic. Moreover, SOA significantly raised management's financial reporting obligations overall and increased appreciably the potential liability of directors, managers, and public companies' external auditors for failure to prevent or detect and deal with financial reporting control deficiencies.

The Alliance does not suggest that SOA Section 404 has been all cost and no benefit. To the contrary, the exercise in process mapping and documentation has led serendipitously to some discoveries of reengineering opportunities. Also, the necessary introspection has uncovered some areas of financial reporting processes that frankly needed reinforcement. Like the certification procedures of SOA Sections 302 and 906, the responsibility to assess publicly—albeit not entirely welcomed—has imparted some increment of sensitivity and commensurate flow-down of duties to persons who should be held accountable.

PCAOB is an integral part of the Section 404 dialogue because the Board must issue the attestation engagement standard for registered public company accountants to follow in evaluating and opining on the assessments of controls made by management. SOA Title I established PCAOB in part to replace the Auditing Standards Board (ASB) in its prior work of issuing generally accepted auditing standards (GAAS). Although PCAOB was authorized by SOA on an interim basis to adopt preexisting standards and the Board did so, the Board elected to issue its own Section 404 standard in lieu of existing alternatives not considered efficacious.

As indicated earlier, the effective date of SOA Section 404 already has been moved once, and little time remains for orderly completion of PCAOB's project and application of the resulting rules to companies with fiscal years beginning on or after June 15, 2004.

General Observations

PCAOB's authority in this matter derives from the SOA sections mentioned earlier, the clearest manifestations of congressional intent being reflected in the statute itself supplemented by related congressional reports and SEC's interpretations to date. In our opinion, certain aspects of the Act and surrounding circumstances are especially instructive as to congressional intent for implementation by the Board.

Principles-oriented approach. In enacting SOA Section 404, Congress clearly sought more visible management accountability to the public with respect to internal control over financial reporting, including an independent party to attest to the reliability (or lack thereof) of management's assessment of the condition of such control. However, Congress was sensitive to the consequences of regulatory burden, took a principles-oriented approach to the law itself, and left the implementing agencies with considerable discretion.

Regulatory burden. Congress had no option in the circumstances of SOA but to enact fairly sweeping revisions, even though many well-managed entities would be treated the same as the small number of poorly governed organizations that precipitated the "crisis of confidence" and related reforms. In addition, Congress knew that private companies, public companies not registered with SEC, and issuers of asset-backed securities would not be affected by the new mandates applicable to many registered public companies. Surely, the regulatory burdens of the latter would be a competitive advantage to the former.

No separate engagement. For reasons just noted, among others, Congress did not intend to encumber processes and relationships unduly. Nor did Congress intend to cause affected parties, including owners and other constituents of public companies, to think that the outcomes of the Section 404-prescribed routines would be failsafe. Although Congress obviously intended to have a management assessment of control over financial reporting and some measure of independent testing leading to public attestation, the latter explicitly was not to have the status of a separate engagement.

Avoiding prescriptive remedies. Purposefully avoiding prescriptive remedies, Congress chose not to stipulate the type or extent of control over financial reporting required by SOA Section 404 or the precise amount or output of attest activity. The object of Section 404 was to induce better accountability for and oversight of financial reporting as part of the SOA mission to reinforce public confidence, but to do so with as little intrusiveness as circumstances would warrant. In section after section of SOA where "command and control" regulation could have been used, Congress simply stated goals or commissioned studies.

One size fits all. We concur in PCAOB's assertion that internal control over financial reporting is not "one size fits all." However, as the Board surely is aware, the final PCAOB pronouncement will, in fact, be a "one size fits all" directive for affected companies. In so stating, the Alliance does not argue in favor of differential treatment for regulated parties. Such variance would only skew further the unanticipated and unintended consequences of the measure as between similarly situated parties, some of whom are affected by the standard whereas others are not. Rather, we recommend leaving much more room for judgment and mutual agreement on how best to address particular facts and circumstances.

Self-governance works. Further on the latter theme, we urge that PCAOB review its proposed standard with care and eliminate unnecessary stipulation of procedures in favor of reciting objectives and principles. Also, we recommend the exercise of professional skepticism about presumed beneficial effects of more rather than less detail. Just as the Board is a self-regulatory body premised on the idea that self-governance can work more efficiently than government edicts, so too might its output reflect such a conviction by establishing goals and allowing incentives, disincentives, and innovation to operate with minimal constraint.

Interpret with reserve. To repeat, SOA occurred in emergency circumstances, and a reasonable bipartisan solution was needed quickly. The circumstances did not admit of surgical remedies so blanket coverage became the order of the day. Congress delegated authority liberally among existing regulators (e.g., SEC, the Financial Accounting Standards Board (FASB), and national securities exchanges), and new standard setters (e.g., PCAOB). Quite clearly, however, Congress also intended that policy interpretation be performed with restraint.

Our recommendations that constitute the remainder of this letter are concerned with regulatory excess, and we strongly urge the PCAOB to abide by a "rule of reason" approach. SOA Section 404 may be the single most demanding provision of the Act, and we believe that the Board's proposal has disruptive potential.

Specific Recommendations

The comments to follow relate to certain paragraphs of the proposed PCAOB attestation standard, and, to the extent not previously addressed, to some of the Board's questions raised in prefatory material accompanying the proposal.

Reasonable judgment (briefing paper p. 3, proposal appendix E). We urge clarification for companies of ***all*** sizes, rather than "small" companies alone by some definition, that the external auditor is to exercise "reasonable judgment" in determining the extent of the audit of internal control over financial reporting and the extent of testing needed to ascertain the effectiveness of that control. Regulatory burden may be somewhat less tolerable for small companies, but certainly affects all entities reached by the standard and is not a function of size alone.

We note further that some of the characteristics cited in appendix E for small- and medium-sized companies often are encountered in entities of all sizes. The PCAOB's generalization about entity affluence and bountiful staff resources as being a factor of size could be misleading.

Inherent limitations (proposal paragraph 15). PCAOB should emphasize that inherent limitations apply in internal control attestation because control is dependent on human diligence and strict compliance. Emphasize further that persons inclined to misbehavior, whether they are acting individually or in conspiracy, may be able to circumvent such control. By underscoring this fact, PCAOB can relieve external auditors of some of the potential litigation risk that otherwise may result in excessive (even duplicative), costly testing.

Auditor competence (proposal paragraph 31, preamble query 5). We recommend that PCAOB ***not*** specify external auditor competence as a factor to be applied in the attestation standard. Avoid any such micromanaging in policy instruments. The proposal is overly complex as it stands. Furthermore, the most competent auditor cannot be expected to identify every actual or potential control deficiency. Auditors already have standards of professional conduct and reputations to uphold, and can be expected to assign competent personnel to the work.

Assessment Process (proposal paragraphs 153 – 182). The Board should direct the external auditor's focus to the adequacy of management's process to determine control effectiveness, with the expectation that the auditor will test to some extent in arriving at a determination as to the integrity of the process and, by extension, the reliability of findings based thereon. Congress ordered (i.e., in SOA Section 404(b)) an attestation to and a report on management's assessment. Whether the auditor focuses on the assessment process or the controls themselves, testing will be part of the routine.

Work sharing (proposal paragraphs 5, 103 - 110). We recommend that PCAOB give flexibility to the section on the external auditor's use of the work of persons acting under the direction of management. Notably, we recommend eliminating the various categories of work and findings that are restricted to the external auditor. Auditor and client need much more leeway to arrive by mutual agreement at a division of labor in conduct of the attest activity. On such a basis, the matter of the auditor's confidence in persons acting at the direction of management is a "given" and need not be addressed in the standard.

Furthermore, since SOA enactment, many companies have conferred on their internal auditors significant independence by means of functional reporting to their audit committees. Internal auditors uniquely are able to perform significant amounts of the testing, and nothing in the standard should prevent auditor and client from reaching a mutually acceptable accommodation.

Walkthroughs (proposal paragraphs 79 - 83). We are not in favor of the requirement of "walkthroughs" of "all significant processes." Certainly the external auditor wants to be satisfied that the control subject to assessment works. However, the auditor logically would use sampling where cost-efficient, and should be expected to rely some on credible work done by others. Again, the latter should be an item for negotiation and mutual agreement, understanding that such agreement will reflect in some measure the external auditor's confidence in client personnel, other client agents, and the control environment generally.

Design/operating effectiveness (proposal paragraphs 84 – 112). PCAOB should reengineer the proposal as it relates to evaluating design effectiveness and the testing of operating effectiveness. We understand the differences between "design" and "operation," but also recognize that effective design bodes well for operating effectiveness. By contrast, the proposal treats these matters as if they were separate and unrelated types of work to be performed, which leaves little to professional judgment and adds needless complexity to the standard.

Sampling and risk assessment (proposal paragraphs 60 – 78, preamble query 16). We think it would be extravagant to require the external auditor ***annually*** to obtain evidence of the effectiveness of control for ***all*** relevant assertions for ***all*** significant accounts and disclosures. In such a mandate, PCAOB would leave little or no room for the external auditor working in conjunction with internal audit to agree on sensible sampling procedures, risk assessment, or the tailoring of test cycles to suit individual facts and circumstances. The auditors, rather than a standard, should determine the propriety of sampling, risk assessment, and cycles.

Re-testing at yearend (proposal paragraphs 94 – 100). SOA Section 404 presents affected entities with a formidable logistical challenge. PCAOB is well advised, in our opinion, to leave to auditor and management collaboration and mutual agreement how much, if any, of control testing during a fiscal year needs to be repeated at yearend for the sake of having an up-to-date evaluation. We urge the abandonment of wasteful requirements for the re-testing for work already performed during the fiscal year. External auditors that have reason to re-test a process for the sake of assurance of integrity can be expected to insist on doing so.

Existing practices (proposal paragraphs 131 – 144). We suggest that PCAOB simplify the "evaluation of test results" and the "forming of an opinion" by leaving room for professional judgment and incorporating wherever possible existing practices applicable in the financial statement audit and such other contexts as are compatible with Section 404 attestation. This SOA Section 404 project may be the Board's first foray into standard setting for audit, but the novelty of the occasion is not a reason to treat the subject matter as if evaluating test results and forming opinions were unprecedented activities for auditors.

Required communications (proposal paragraphs 190 – 193). We candidly have mixed reactions to these provisions. We certainly favor communication of significant findings, and the escalation provisions as to reporting to management or the audit committee seem logical. Also, issues of fraud clearly should be handled in a manner consistent with AU sec. 316. As for timely communication, the matters of "relative significance" and "urgency of corrective follow-up action" are best left to professional judgment. The proposal seems to us less than transparent for that purpose, so we suggest that PCAOB revisit the issue.

Tone at the top (proposal paragraphs 19 – 20, 41 – 47, 56 – 59). To the extent possible, SEC and PCAOB might better orient their SOA Section 404 activity to processes followed at higher levels in affected companies. The ill-governed organizations that precipitated the Act almost universally were corrupt, inept, and/or ineffective at levels in the organization that had oversight responsibility. The Board's proposal, if it had been adopted and blessed with complete compliance at some earlier date, would not necessarily have curbed the malfeasance that resulted in the Act.

Some of the paragraphs cited for this comment seem to envision audit of the audit committee role in control over financial reporting. As PCAOB may be aware, a number of audit committees have adopted use of their own control self-assessment (CSA) routines, and the movement appears to be spreading. We think that the standard should take this into consideration with a view to economizing on audit committee time commitment for SOA Section 404 control testing purposes.

Attest or audit (preamble query 1). PCAOB asks, in essence, whether the process it is standardizing should be characterized as "audit" or "attest." To some parties, the question might seem to be an exercise in semantics. However, an audit is a task with very specific meaning in the profession, as the Board is aware, and is an activity of more consequence than "reviews" or lesser activities by external auditors. Rather than complicate an area where potential liability already is in question, PCAOB might be well advised to regard the task as attest only. We have used the words interchangeably in this letter because the Board has done so in its release.

In conjunction with financial statement audit (preamble queries 2 - 3). The question, to summarize, is whether Section 404 attest always should be done in the context of financial statement audit. We would like to think otherwise if the added flexibility would translate into operational economies, less intrusiveness, and lower fees. The issue is with the wording of the statute. If PCAOB has a way to lessen the burden of Section 404 by re-characterization or otherwise without offense to the legislation, we suggest that the idea at least be explored.

Scope of the audit (preamble query 6). Basically, PCAOB inquires whether it is appropriate for the Board to be requiring auditors to evaluate management's assessment while also requiring that the auditor perform various procedures directly. As noted earlier, PCAOB should take every opportunity to reduce the unwieldy transaction cost of this standard. To restate our earlier remark, the Board is putting the external auditor in a position of auditing work that may already have been performed (or could have been done) by internal audit or other management-directed parties on whom the external auditor could rely, assuming sufficient confidence. We recommend leaving more discretion to the parties.

Inadequate documentation (preamble query 8). We do not think that inadequate documentation necessarily is a control deficiency. The suitability of documentation will vary with individual circumstances. One size truly does not fit all, as PCAOB has contended. Appendix E appropriately so indicates although, as noted, the generalization about businesses of certain sizes could be misleading.

The Alliance again thanks PCAOB for this opportunity to comment on Rulemaking Docket Matter No. 008. Should you have questions about any of the foregoing, please do not hesitate to call me at (703) 841-9000.

Respectfully submitted,

F W Holman Jr.

Francis W. Holman, Jr.
Vice President and Secretary

October 28, 2003

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

Re: PCAOB Rulemaking Docket Matter No. 008– An Audit of Internal Control Over Financial Reporting Performed In Conjunction With An Audit of Financial Statements (PCAOB Release No. 2003-017)

Dear Mr. Secretary:

I am pleased to submit this comment letter to the Public Company Accounting Oversight Board ("PCAOB" or the "Board") regarding the above-referenced PCAOB Rulemaking Docket matter. Overall, Marriott Internal Audit supports the proposed auditing standard. Our views and significant comments on this proposed audit standard are set out in this letter.

Perspective
In my role with internal audit, I have been actively involved in Marriott's internal control evaluation since joining the Company in 2001 and have worked closely with management and our external auditors to develop and implement an approach to achieve compliance with the requirements of Sarbanes-Oxley, since July 2002.

Expectations
I expected the Board to propose an audit standard which would clearly define responsibilities of management and the external auditor and provide a framework against which internal and external auditor's could evaluate approaches and chart as direct a course as possible and appropriate toward compliance.

Reaction/Suggestion/[responses to specified questions posed by the PCAOB in the preface to the proposed audit standard]
I was generally pleased to see that the proposed standard supports the approach Marriott has employed since early 2003.

That said, I believe that the guidance for management's documentation of internal controls could be improved, the standards should more clearly define how management and external audit efforts can be coordinated, and the guidance for reporting on management's assessment of internal control should be clarified.

Management's documentation of internal controls
Per recent discussions with my counterparts at several large public companies headquartered in the Washington and Baltimore areas, one noted that, "at least with respect to management's documentation of internal controls, it appears that the Board has responded to a plea to issue principles-based standards" (a plea "echo'd" by many of the participant's in the recent PCAOB roundtables). Another noted that, "the standard supports my adherence to the COSO framework and

focus on key controls. I won't need to document the entire control process to the extent I don't plan to test the controls."

I interpret the standard to be far from principles-based and although I understand it to require management to base its assessment on a recognized control framework, the reference to AU 319 tells me that the framework is secondary to the requirement that the auditor and hence management must document controls in place to achieve financial statement assertions related to all significant accounts. The requirement of the external auditor to perform walkthroughs (paragraph 79) indicates to me, that management's documentation must support this walkthrough in order to be deemed complete by the external auditor.

Room for interpretation is room for misinterpretation. I won't presume my interpretation to be more correct that any of my peers in internal audit, but I do request that the Board recognize that there are different interpretations of the requirements of the standard with respect to documentation, and to consider revising the proposed standard to clarify the required documentation of internal controls. To restore the faith and trust of the shareholders of public companies and employees of those companies, it will not do to broaden the expectation gap or put management of public companies at odds with external auditors (who are instructed in the standard to conclude whether inadequate documentation of controls by management represents a deficiency, significant deficiency, material weakness or scope limitation) over the sufficiency of documentation supporting their assessment.

I believe the only way to ensure that internal controls are consistently documented from one entity to the next, and thereby ensure that each is measured against a similar standard will be to provide illustrative guidance in the standard regarding the use of an internal control framework and specificity with regard to components and organization of the documentation (combining and expanding upon the documentation requirements for management and the external auditor in paragraphs 43 and 145 in the standard, to include example evaluation tools, and examples of complete documentation for various financial reporting subprocesses).

Coordination of internal and external audit efforts
As corporations rolled-up their sleeves to address the requirement for an audit of internal control over financial reporting with an internal and external assessment component, it was logical for management to coordinate the work with the external auditor to ensure that there was agreement with respect to the scope and approach and eliminate redundancy in the process. The proposed standard does not provide a clear roadmap and timeline for management and the external auditors to follow and appears to drive a wedge between the two by going beyond previous independence requirements. In my opinion, the resulting inefficiencies will result in excessive costs, which is counter to the premise that this requirement will protect the shareholder, as they ultimately bear this burden.

I recommend that the Board enhance the proposed standard to include illustrative guidance regarding acceptable approaches which maximize efficiency of the process while producing reliable evidence to support conclusions (e.g. outline of recommended steps in management's assessment and the external audit of internal control over financial reporting, a suggested/permissible timeline for each of the recommended steps, and acceptable alternative strategies for each project step (i.e. who can perform, criteria for the use of the work of others, nature and extent of testing, suggested touchpoints for the coordination of the internal and external assessments)). This guidance, in my opinion should refrain from indicating when external auditors should not use or limit the use of work of others, and instead describe criteria which must be met to enable external auditors to rely on the work of others including internal audit and management. The guidance should also describe when and how management and external auditors can and should collaborate to identify the appropriate controls to test, and coordinate sample selection for testing and execution of tests of controls, to eliminate redundancy. I believe existing standards and practices by many of the public accounting firms support integration of the plan and execution of an audit of internal control, while maintaining a strong basis for reliable independent reporting.

[Response to PCAOB questions: #10 – In my opinion, the requirement for an external auditor to perform walkthroughs is inappropriate. The standard should define the nature and extent of walkthroughs required and documentation prepared to provide an adequate basis for an opinion regarding the design of controls. The standard should provide guidance to the auditor regarding the nature and extent of procedures to validate the work performed by others, but not preclude it. #12 – As indicated above, I believe the auditor should be permitted to use the work of management and others in the performance of their review. Changing the focus of the standard in this regard to guidance for appropriate validation procedures will enable the management, internal and external auditors to plan the most efficient and effective use of resources to accomplish the same objective. #13 – I believe that taking action as recommended in my response to #12 , above will eliminate the need for any guidance regarding the any specific categories of controls which the external auditor need vary his/her approach. Paragraphs 104, 105 and 106 clearly describe the categories of controls that external auditors have historically used to plan a mix of procedures (tests of controls vs. substantive) for their external audit. I expect external auditors to continue to do more substantive work on financial statement captions whose underlying controls fit into the categories described in paragraph 104 and 105, but the level of work performed by others should have no bearing on the auditors ability to conclude on the effectiveness of controls in these categories, as long as the evidence is sufficient. #16 – The external audit should obtain and retain the principal evidence to support his/her opinion in the audit documentation, but the quality and sufficiency of this evidence should be the focus of the standard. While the external auditor must consider the source of evidence and the qualifications and independence of the persons who perform testing to conclude on the reliability of audit evidence, the auditor should be permitted to perform that evaluation and use the work of others, where appropriate.]

Reporting on management's assessment of internal control

I believe that standard should include an illustrative report of management's assertions in addition to those included for the external audit opinion, and that the illustrative reports should clearly describe the criteria applied in a manner that the users of financial statements can understand. As an auditor who has used COSO since it was first published, I consider myself reasonably well-versed in the framework, yet I do not think the definition of criteria in the COSO framework is clear (glossary has one definition under criteria, another under reliability of financial reporting, and the evaluation criteria under each of the components indicates that it is not all-inclusive, serves as a starting point, or otherwise requires further evaluation and judgment of the auditor/evaluator), and therefore I believe it would be inappropriate to simply state in the report that management's assessment was based on criteria established in COSO.

Other considerations and concerns

It is no secret that there were horrendous practices in food and drug preparation in the United States during the 19th century, and "The Jungle" was not the first call to action, but early last century Theodore Roosevelt heard the call and responded with the Food and Drug Act of 1906. It is likewise well known that Enron and WorldCom do not represent the first or only examples of the failure of corporate governance processes of United States corporations. Due to the increasing numbers of Americans investing in marketable securities, this crisis has the potential to harm as many Americans as the poisoning of our food sources a hundred years ago, and congress has appropriately responded through the Sarbanes-Oxley act. Now only time will tell if the PCAOB will benefit our citizens and endure through challenge and change, as has the FDA.

I think it is safe to say that most if not all professional auditors and probably most executives would rather work with the PCAOB to successfully bear this burden now and create a process that will last, than wait for more and potentially more devastating corporate failures and for the Upton Sinclair of the 21st century to call us out for not having done enough.

I don't intend for my reference to Sinclair to suggest that I would support the socialization of auditing or corporate management for that matter, just the opposite. I believe that we did better to leave the meat packing to meat packers and we should do the same for audit and management, but I draw the parallel to highlight my concern that if we don't monitor the unintended consequences of the change brought on as a result of Sarbanes-Oxley, the audit profession could be so negatively impacted that it will not continue to function effectively for all public companies.

Evidence that the significance of increased costs of being a public company is a reality for many companies is more and more often born out in the media. Executives have referred to the effects of Sarbanes-Oxley as chemotherapy on the more positive (painful, but in the end we will be better off), as a reason to take companies private, and as sand being poured into the gears of the economy. I hope that the U.S. Securities and Exchange Commission (SEC) and the PCAOB take an increasingly active role in molding public opinion; responding to criticism, as appropriate, and addressing negative unintended consequences as they arise.

Improving corporate governance should not be so costly or result in such an elevated risk profile that our professional accounting firms are forced to decline future audit work and/or potentially force public companies to go private to avoid the cost of the regulations.

There are so many moving parts in this equation that a final solution may not be possible without the benefit of experience, and I applaud the Board for the efforts to date related to the adoption and development of audit standards for the audit of internal control over financial reporting. In a different era, the approval of the proposed standard would simply be an exercise in tweaking the mechanics of an attestation engagement to make a handful of audit professionals happy and arm 10's of thousands of auditors with guidance to plan their reviews. Today it is so much more. This standard is a critical element of the PCAOB's arsenal to achieve its mission 'to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports'. At the same time, the unintended consequences of the implementation of this standard as a basis for companies to comply with the SEC rules may in fact be at odds with the mission of the SEC, 'to protect investors and maintain the integrity of the securities markets'. It would be advisable at this point to take a step back and evaluate the plans to achieve each mission and determine possibly through additional studies, if the existing plans should be reworked.

I appreciate your consideration of my comments on the proposed standard and other considerations.

Sincerely,

Matthew Gagnon
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From: Matthew Leitch [m.leitch1@ntlworld.com]
Sent: Saturday, November 08, 2003 8:36 AM
To: Comments
Subject: Docket 008

A more modern audit technique would be more efficient and effective

The proposed rule shares a significant deficiency with the AICPA's guidance on the same topic which had previously been influencing companies' approaches to SOX 404 compliance. Its audit approach to internal controls is rather old fashioned, being based on the old model of control objectives, controls, and tests of the operation of controls.

An audit approach based on more modern ideas of risk assessment and management, and a wider understanding of "testing" would produce more convincing evidence of controls effectiveness at lower cost to everyone.

An evaluation based solely on assessing design effectiveness and operation of individual controls is unreliable because it is extremely hard to assess design effectiveness accurately. Inherent error and fraud rates are hard to estimate to within an order of magnitude and it is very easy to be surprised by obscure and indirect errors and frauds. In practice, when control systems are designed it is vital to gather and study information on actual errors and frauds discovered and modify the design.

The rules should emphasise the importance of direct evidence of the effectiveness of controls from statistics about actual errors and frauds discovered. This might be done by expanding the concept of testing and by commenting on the value of direct evidence in other parts of the document. This should be presented as one more form of evidence that could be used, rather than a requirement. The principle involved is already in the rule, where it says that mis-statements found during audit of the financial statements should be considered when assessing the effectiveness of internal controls.

The main benefit would be with large scale financial processes, which is where the main costs of audit lie. With these many companies should be able to provide *measured effectiveness* to back up their assessments of their control activity. Work that might have taken weeks can be done more effectively in days.

There are a number of limitations and points to consider. They are explained in my document: "Sarbanes-Oxley Act section 404 and 302: *efficient* compliance (updated)" which is at http://homepage.ntlworld.com/m.leitch1/icd/effectiveness/index.html.

Matthew Leitch
Matthew Leitch Associates Limited

About the author of this comment

Matthew Leitch is an independent consultant in risk management and internal control. Until late 2002 he was an internal controls specialist and external auditor with PricewaterhouseCoopers. His experiences on an early SOX 302 project for a major US company convinced him that there was a better way to do the reviews than relying exclusively on documenting and testing operation of individual controls.

November 18, 2003

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

RE: Invitation to Comment on PCAOB Rulemaking Docket Matter No. 008

Dear PCAOB:

I wish to comment on the proposed auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With An Audit of Financial Statements*.

My comments are limited to three issues:

a) **your question 1:** use of the phrase "audit of internal control over financial reporting"
b) **your question 27:** wording in the non-standard opinion paragraph; and
c) **general:** your use of the phrase "fairly stated in accordance with generally accepted accounting principles"

(a) Use of the phrase "audit of internal control over financial reporting"

Those involved in accounting, financial reporting and auditing will easily understand this phrase. However, for those not directly involved, its similarity to the phrase "audit of financial statements" is potentially problematic. I include in this possibly confused group readers and analyzers of financial statements, as well as representatives of the media.

My concern is that well meaning people will be speaking or writing about one of these audits (say, financial statements) to listeners who may be thinking about the other (say, internal control). This confusion would be ironic considering that transparency is probably the most desired outcome of Sarbanes-Oxley.

It would not be practical to change the long-standing phrase "audit of financial statements." We are left then to find a substitute for "audit of internal control over financial reporting." I suggest the following phrase: "independent assessment of internal control over financial reporting."

Furthermore, I note that the title of each of your example reports (A-1 through A-6) is "Independent Auditor's Report." I see this as another source of confusion. In my view, "Independent Auditor's Report" is much too associated with the audit of financial statements to use it in any other context.

(b) Wording in the non-standard opinion paragraph

Your proposed wording in a non-standard opinion speaks directly to the effectiveness of the internal control over financial reporting rather than to whether management's assessment is fairly stated.

I suggest that we use the non-standard audit opinion on financial statements as a guide to evaluate your proposed wording.

- If the auditor concludes that financial statements are fairly stated, the opinion so indicates.
- If an adverse opinion is to be expressed, the opinion expressed is: "… the financial statements … are not fairly stated."

Your suggested wording for an unqualified opinion re: internal control over financial reporting is as follows:

- "…management's assessment that Company W maintained effective internal control … is fairly stated."

To be consistent with the financial statement audit approach, the logical counterpart when an adverse opinion is to be expressed should be as follows:

- "…management's assessment that Company W maintained effective internal control … is not fairly stated."

Also, it is important to note that your suggested wording of "… has not maintained effective internal control …" is not consistent with the introductory paragraph's claim that "… our responsibility is to express an opinion on management's assessment."

(c) Use of the phrase "fairly stated in accordance with generally accepted accounting principles"

Under Section 302 of Sarbanes-Oxley, CEO and CFO certifications include that:

> "… financial information … fairly presents the financial condition, results of operations and cash flows."

In my view, it is notable that, in this certification, fair presentation is <u>not</u> modified by "in accordance with generally accepted accounting principles." I believe that this is not an accidental omission - I assume that it is an intentional clarification (by omission) that GAAP compliance does not necessarily result in fair presentation.

But, paragraph 6 of your proposed standard refers to " … preparation of financial statements … in accordance with generally accepted accounting principles…" It seems to me that the PCAOB (and the SEC) needs to decide exactly what role GAAP compliance should play in this new reporting environment. Failure to spell this out seems, in my opinion, to be quite unfair to CEOs, CFOs, preparers, audit committees and auditors.

As a sidebar, the standard audit report on financial statements refers to the source of GAAP and generally accepted auditing standards. This recognizes both the global nature of the reporting environment and fast developing international standards. I suggest that your references to GAAP or GAAS be specific (for example, US-GAAP) or that, through footnote(s), you explain the role, if any, of non-US sources of GAAP and GAAS.

Yours truly,

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November 21, 2003

Office of the Secretary
Public Company Accounting Oversight Board
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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*

Dear Mr. Secretary:

McGladrey & Pullen, LLP is pleased to submit written comments on the proposed auditing standard, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*. McGladrey & Pullen, LLP is a registered public accounting firm serving middle-market issuers.

Although we do have some suggestions that we believe would improve the proposed standard, we want to acknowledge the substantial effort by the Board and its staff in drafting the proposed standard, as well as applaud the result. Overall, the proposed standard is well thought out and, in our opinion, strikes an appropriate balance between the work effort required to support management's assessment and the work effort required to support the auditor's attestation. We also want to acknowledge the significant contribution of the Auditing Standards Board in submitting its recommendations concerning this proposed standard to the PCAOB.

Executive Summary

Evaluating Controls over all Relevant Assertions Related to all Significant Accounts and Disclosures

The proposed standard provides, in paragraph 41, that in order to evaluate the effectiveness of the company's internal control over financial reporting, management must have evaluated controls over all relevant assertions related to all significant accounts and disclosures. The proposed standard further provides, in paragraph 69, that the auditor should identify the points within each significant process where a misstatement related to each relevant financial statement assertion could arise, and in paragraph 74, that the auditor should obtain evidence about the effectiveness of controls for all relevant assertions related to all significant accounts and disclosures. These requirements appear to ignore the concept of *inherent risk, i.e., the susceptibility of an assertion to material misstatement, assuming there are no related controls*, set forth in the interim auditing standards adopted by the Board (see AU 312.27-.29).

Accordingly, we do not believe that these requirements should extend to each/all relevant assertions when inherent risk for those assertions has been appropriately assessed as low. However, consistent with the requirements in the interim auditing standards to perform substantive tests for all significant accounts and disclosures, we do support a requirement to identify potential misstatements and evaluate and test controls for all significant accounts and disclosures.

Performing Walkthroughs

We support a requirement to perform walkthroughs. However, the proposed standard provides, in paragraph 79, that for significant processes, the auditor should trace all types of transactions and events through the process, from origination through the company's information systems until they are reflected in the company's financial statements. We believe that the requirement to trace all types of transactions and events is unnecessary and overly burdensome because certain types of transactions and events that are not individually significant are processed through significant processes.

Extent of Tests of Controls

The proposed standard, in paragraph 101, requires that each year the auditor must obtain *sufficient* evidence about whether the company's internal control over financial reporting is operating effectively. However, we believe that, consistent with the interim auditing standards for financial statement audits adopted by the Board (see AU 319.97-.98), evidence obtained about the effective design or operation of controls that was obtained in prior audits can be considered by the auditor in determining the nature, timing and extent of evidence required in the current audit. In any event, the auditor would always need to obtain evidence about whether changes in controls have occurred subsequent to the prior audit and obtain sufficient evidence about the controls continued operating effectiveness in the current audit. In determining the extent of evidence required in the current audit, the auditor should consider the significance of the assertion and account or disclosure involved, the nature of the controls, the degree to which the controls were evaluated in the prior audits, and the results of the tests of controls performed in prior audits.

Relationship of an Audit of Internal Control to an Audit of Financial Statements

The proposed standard, in paragraph 138, states, "Regardless of the assessed level of control risk or the assessed risk of material misstatement in connection with the audit of the financial statements, the auditor should perform substantive procedures for all relevant assertions for all significant accounts and disclosures. Performing procedures to express an opinion on internal control over financial reporting does not diminish this requirement." While we agree with the second sentence, we believe that the first sentence mischaracterizes the requirements for an audit of financial statements contained in the interim auditing standards adopted by the Board (see AU 312.32 and AU 319.107). Those standards only require that an auditor perform substantive tests for significant account balances and classes of transactions, not for each relevant assertion within those accounts or classes. We assume it was not the Board's intent, and we do not believe that it would be appropriate, to make such a significant modification to the financial auditing standards through the issuance of this standard.

Documentation of the Effect of a Conclusion that Control Risk is Other than Low

The proposed standard, in paragraphs 146 and 147, requires an auditor to document the reasons for a conclusion that control risk is other than low for any relevant assertions for any significant accounts and the effect of that conclusion on the auditor's opinion on the effectiveness of internal control over financial reporting. We believe that an auditor should not be required to specifically test controls over all relevant assertions if inherent risk with respect to that assertion is appropriately assessed as low. Accordingly, the auditor would not have a basis for assessing control risk as low. In such cases, we believe that the auditor should be required to document the basis for the inherent risk assessment rather than the reason for and the impact of the control risk assessment. This comment should be read in the context of our preceding comments.

Effect of a Material Weakness on the Auditor's Report

The proposed standard, in paragraph 162, requires the auditor to express an adverse opinion on the effectiveness of internal control over financial reporting if a material weakness is identified. The SEC's rules implementing Section 404 of the Sarbanes-Oxley Act preclude management from concluding that internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting. Regardless of whether management must then conclude that internal control over financial reporting is not effective or is permitted to qualify its assessment, we do not believe the public interest is served by the auditor being required to issue an adverse opinion. We believe, as with an identified material misstatement of the financial statements, the auditor should apply professional judgment to determine whether to issue a qualified or an adverse opinion. A qualified opinion might be appropriate, for example, if the material weakness affects only one process and the resulting risk of material misstatement is limited to specific account balances, classes of transactions or disclosures.

Authoritative Appendices

We believe that appendices should be reserved for interpretive guidance and should not be used for standards. Accordingly, we believe it is inappropriate to include imperative statement or otherwise imply that any particular procedures are required in the appendices.

Responses to Questions

Questions regarding an integrated audit of the financial statements and internal control over financial reporting:

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?**

   Yes. We believe that it is appropriate because the term *audit* is better understood by the public and the objective, procedures and assurance provided in attesting to management's assessment of the operating effectiveness of internal control are substantially the same as the objective, procedures and assurance provided in an audit of financial statements.

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?**

   Yes. The Sarbanes-Oxley Act of 2002 specifically provides that the auditor's attestation of management's assessment of internal control shall not be the subject of a separate engagement. It is clear therefore, that Congress intended that the audit of internal control and the audit of the financial statement s be conducted as an integrated audit. Because of the potential significance of information that might come to the auditor's attention in performing the audit of internal control to the audit of the financial statements (and vice versa), we concur that an auditor should be required to perform both audits concurrently.

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?**

   No. As previously noted, the Sarbanes-Oxley Act of 2002 specifically provides that the auditor's attestation of management's assessment of internal control shall not be the subject of a separate engagement (separate from the audit of the financial statements). In addition, we do not believe it would be possible to specify the nature, timing and extent of work that would be required to be performed in order for that work to be "comparable to that required to complete the financial statement audit".

Question regarding the costs and benefits of internal control:

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?**

   No. The standard should clearly state that the objectives of internal control at small and medium-sized issuers are the same as for larger issuers. In addition, we do not find Appendix E to be helpful in distinguishing between the types of controls that might be effective in small and medium-sized issuers and those that would be effective in larger issuers.

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.**

   No. Since the Board has proposed this standard as an auditing standard, engagements performed in accordance with this standard would be subject to the general and fieldwork standards, as well as the planning and supervision standards contained in the interim auditing standards adopted by the Board. Those standards require that the audit be conducted by persons with adequate technical training and proficiency, that due professional care be exercised in the performance of the audit, and that the work be adequately planned and assistants be adequately supervised.

Questions regarding evaluation of management's assessment:

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. In order to issue an opinion on management's assessment, the auditor must obtain evidence that management's assessment is accurate. It would be inappropriate for the auditor to issue such an opinion based solely upon an evaluation of the process used by management to make the assessment.

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

Yes. Absent such criteria, it would be difficult, if not impossible, for the auditor to understand and evaluate the process used by management to assess the effectiveness of the issuer's internal control over financial reporting.

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?

Yes. We do not believe that inadequate documentation would necessarily rise to the level of a significant deficiency or material weakness. As with any other internal control deficiency, the assessment of the significance of a documentation deficiency is a matter of professional judgment that should be made in consideration of the relevant facts and circumstances surrounding the deficiency.

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. Our firm has long required the performance of walkthroughs in audits of financial statements in order to confirm the accuracy of our understanding of the design of processes and controls and to determine that they have been placed in operation. Accordingly, we support the requirement in the proposed standard to perform a walkthrough for all of the issuer's significant processes. We do not, however, support the requirement to trace all types of transactions and events within a significant process from origination until reflected in the financial reports because we believe that requirement to be all encompassing and contrary to the overall objective of providing reasonable assurance on management's assessment.

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?

Yes. Since the objective of walkthroughs is to confirm the auditor's understanding, we do not believe that the performance of walkthroughs can be delegated to others.

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?

No and yes. We believe that the auditor should be required to obtain evidence of the effectiveness of controls for all significant account balances and disclosures, but not necessarily all relevant assertions within each significant account balance or disclosure, each year. Because we believe the concepts of reasonable assurance and audit risk apply to audits of the effectiveness of internal control over financial reporting performed in conjunction with an audit of financial statements, we believe that evidence of operating effectiveness obtained by the auditor in recent prior years should be considered by the auditor in determining the nature, timing and extent of evidence to be obtained in the current year.

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?

Except for the performance of walkthroughs and the evaluation of the control environment, we believe the auditor should be permitted, but not required, to use the work of management and others, provided the auditor has concluded that their competence and objectivity warrants such reliance. In certain cases, we believe the auditor's use of management and others should be limited, and we agree that the auditor must obtain the principal evidence to support his or her opinion.

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

Yes. However, we believe that the auditor's use of the results of procedures performed by management and others for "controls over the period-end financial reporting process" and "controls that have a pervasive effect on the financial statements" should be limited rather than prohibited. For these two categories of controls, the in-depth understanding and technical competence possessed by these individuals may be critical to performing an evaluation of the effectiveness of such controls, and in the presence of an effective control environment, they should be in a position to objectively perform the procedures.

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?

Yes. We believe that the proposed standard appropriately recognizes that, for issuers whose internal auditors are highly competent and objective, the auditor may place increased reliance on their work, while also cautioning the auditor that, in some cases, the competence or objectivity of internal auditors may be insufficient to warrant increased reliance.

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)?

Yes. The extent of the reperformance will depend on a variety of factors, including the auditor's assessment of the competence and objectivity of the persons who performed the work, as well as the auditor's assessment of the importance of the control and the likelihood that it might fail to perform as designed.

16. Is the requirement for the auditor to obtain the principal 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?

Yes. We strongly believe that, in all cases in which an auditor expresses an opinion, the auditor's own work should provide the principal basis for that opinion. This requirement provides an appropriate overall limit on the auditor's ability to use the work of management or others.

Questions regarding evaluating results:

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?

No. It appears that the intent was to characterize a *significant deficiency* as a deficiency that results in more than a remote likelihood of *a misstatement that is not inconsequential* and a *material weakness* as a deficiency that results in more than a remote likelihood of *material misstatement*. However, as written, there is an inadequate distinction between *significant deficiency* and *material weakness*. Following are our suggestions on how these two definitions could be improved:

> A *significant deficiency* is an internal control deficiency, or combination of deficiencies, that adversely affect the company's ability to initiate, record, process or report external financial data to a degree that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected.
>
> A *material weakness* is a significant deficiency, or a combination of significant deficiencies, that result in more than a remote likelihood that a material misstatement of the company's annual or interim financial statements will not be prevented or detected.

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?

Yes and no. Our experience has shown that, once you go beyond simple examples, it is impossible to provide sufficient facts for competent professionals to consistently reach the same conclusion. Accordingly, we recommend that additional examples not be provided.

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

Yes. Once an auditor identifies an internal control deficiency, the auditor needs to evaluate whether it is a significant deficiency or a material weakness.

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?

No. For internal control deficiencies originally identified by others, the auditor should be required to determine that management has been informed of the deficiency, but should not be required to re-communicate the deficiency or to reference the prior communication. However, an auditor should be required to communicate to management all internal control deficiencies originally identified by the auditor in the audit of internal control or the audit of the financial statements. Management, not the auditor, is responsible for evaluating the cost/benefit relationship of responding or not responding to internal control deficiencies. An auditor who makes a conscious decision not to communicate to management internal control deficiencies originally identified by the auditor has assumed a management responsibility.

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

Yes, for the most part. However, we believe that the absence of sufficient evidence to support the responsible party's evaluation of the operating effectiveness of internal control should be included in this category. In addition, we believe that an ineffective regulatory compliance function would result in a significant deficiency (and a strong indicator of a material weakness) only if it has a direct or material indirect effect on internal control over financial reporting. Finally, we believe that it is an over generalization to conclude that fraud *of any magnitude* on the part of senior management should be included in this category, especially if it was detected by the company's internal control.

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, however, we believe the proposed standard should make it clear that in order to have a sufficient basis for its assessment, management would also need to evaluate the effectiveness of the audit committee's oversight.

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

Yes. Provided the standard is clear that the auditor is not expected to make a legal evaluation, auditors have the objectivity and technical competence to make this evaluation. In addition, we suggest the auditor's responsibility to evaluate the independence of the audit committee be limited to consideration of observable information and behavior.

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. In these circumstances, the auditor should not be required to withdraw from the audit engagement. The public interest would be better served by the auditor issuing an adverse opinion on the effectiveness of internal control over financial reporting, and potentially a disclaimer of opinion on the financial statements, as a result of ineffective audit committee oversight than by the auditor's withdrawal from the engagement(s).

Questions regarding forming an opinion and reporting:

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?

No. When the financial statements are materially misstated, the auditor evaluates the significance and the pervasiveness of the misstatement in deciding whether to express a qualified or adverse opinion. Similarly, we believe that when a material weakness is identified, the auditor should evaluate the significance and pervasiveness of the resulting risk of material misstatement, and in his or her professional judgment, determine whether to express a qualified or adverse opinion.

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

Yes. We believe that where the potential for material misstatement of the annual or interim financial statements is neither overwhelmingly material nor pervasive to the financial statements taken as a whole, a qualified opinion would be appropriate because it adequately informs the public of the risk of material misstatement.

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?

Yes. We do not believe that it would serve the public for an auditor to be permitted to express an unqualified opinion on management's qualified assessment or to issue a qualified opinion on management's unqualified assessment. Accordingly, in those circumstances, an auditor's report should speak directly to the effectiveness of internal control over financial reporting.

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?

No. We do not believe that this proposed standard is the appropriate place for guidance on independence and internal control-related non-audit services. We believe that the issue of auditor independence related to internal control services should be viewed in the broader context of overall auditor independence.

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

Yes. We believe that independent auditors can provide non-audit internal control-related services to their clients, with appropriate audit committee pre-approval, and within strict parameters that do not place the auditor (a) in the position of auditing his or her own work, or (b) in the capacity of management or an employee of the audit client. However, we believe that an auditor should not perform the following specific non-audit services for his or her audit client because they violate these overarching principles:

- Designing, implementing, operating or supervising the operation of any element of an audit client's internal control over financial reporting.
- Performing any internal audit services that relate to internal controls over financial reporting.
- Designing or implementing software or hardware systems that aggregate source data underlying the financial statements or generate information that is significant to the audit client's financial statement taken as a whole.

- Assuming responsibility for documenting the client's internal control over financial reporting.
- Performing the evaluation required of management for purposes of its assessment of the effectiveness of internal control over financial reporting.
- Performing internal control testing required of management for purposes of its assessment, including situations where the auditor chooses sample size, decides on tests to perform, or provides software that concludes as to the effectiveness of controls.

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. A different level of responsibility is implicit in the level of responsibility the auditor assumes in a review of the interim financial statements versus an audit of the annual financial statements.

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

Yes, however, we do not believe that the requirements with respect to quarterly certifications should become effective until the first quarter after the annual assessment becomes effective.

Thank you for the opportunity to comment on this proposed standard. Questions concerning our comments should be directed to Bruce Webb, National Director of Auditing (515.281.9240) or Leroy Dennis, Executive Partner – Audit & Accounting (952.921.7627).

Very truly yours,

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William T. Kerr
Chairman and
Chief Executive Office

March 4, 2004

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

Dear Board Members:

I am pleased to have the opportunity to comment on the Public Company Accounting Oversight Board's (the "PCAOB") proposed auditing standard relating to an audit of internal control over financial reporting in conjunction with an audit of financial statements (the "Proposed Standard").

By way of background and perspective, I am chairman and chief executive officer of Meredith Corporation, a company listed with the New York Stock Exchange (the "NYSE"). I also serve as a member of the board for certain other public companies listed with the NYSE – including service on audit and governance committees. The comments I express in this letter represent my views and the views of Meredith Corporation only and do not necessarily represent the views of the other companies I serve.

I recognize the significant efforts put forth by the PCAOB in developing the Proposed Standard. I am very concerned, however, about the requirement that external auditors evaluate the effectiveness of the audit committee. This requirement is inconsistent with the structure of corporate governance and it creates the potential for a conflict of interest for the audit committee and the auditors. Furthermore, the external auditors do not have the necessary background and access to fully perform the evaluation contemplated by the Proposed Standard, nor should such an evaluation, if it were to be performed, be separate from the overall evaluation of internal controls over financial reporting.

The audit committee is an important element in the governance structure of a company, but it should not be considered a separate element of the company's system of internal control over financial reporting. The audit committee is independent of management. Its role is to provide oversight and evaluate management's performance. It is management that is directly responsible for the company's system of internal control over financial reporting, a system which should stand on its own without the direct involvement of the audit committee.

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The external auditor should be evaluating management's system of internal control over financial reporting. The board of directors, which has established the audit committee and has the ability and responsibility to replace committee members and alter the audit committee charter, is the proper body to evaluate the committee's effectiveness. In fact, under the NYSE listing standards, the board and its audit committee must conduct an evaluation of their own performance, at least annually. If the external auditors insist on reviewing the results of this self-evaluation as part of their audit procedures, as seems likely under the Proposed Standard, the effectiveness of this self-evaluation could be diminished by restricting open and free self-criticism among board and audit committee members.

I am also concerned that requiring the external auditor to evaluate the performance of the audit committee could create a conflict of interest. Such a standard would require that the auditor pass judgment on the body to which it directly reports and that, under Sarbanes-Oxley, is solely responsible for hiring it, firing it, overseeing its performance and mediating disputes between it and management.

Furthermore, external auditors ordinarily do not have full and complete knowledge of all of the audit committee's activities, interactions with other parties, deliberations, and conclusions reached. In addition, they do not have the necessary legal background to evaluate factors such as the independence of audit committee members and compliance with applicable listing standards.

Finally, to the extent that the external auditors were to give any consideration to the audit committee's oversight of the system of internal control over financial reporting, this consideration should be for purposes of their overall evaluation rather than to separately conclude on the effectiveness of the audit committee.

For the foregoing reasons, I believe that the provisions of the Proposed Standard that relate to the external auditors' evaluation of the effectiveness of audit committees should be eliminated.

I appreciate your consideration of these comments, and I will be happy to discuss these matters further or to meet with you if it would be helpful.

Very truly yours,

William T. Kerr

William T. Kerr

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October 27, 2003

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

Subject: Rulemaking Docket Nr. 008 Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

Members and Staff of the Public Company Accounting Oversight Board:

Thank you for the opportunity to comment on the proposed auditing standard on an audit of internal control over financial reporting performed in conjunction with an audit of financial statements. I have had exposure to external audit, internal audit and preparing financial statements as a finance director before returning to academic life to pursue a PhD on internal control over financial reporting. As a result, I hope that my comments reflect a balanced view, which is based on insights from professional experience and research. I appreciate the amount of work that has been invested into the Proposed Auditing Standard by the PCAOB.

Overall, I support the proposed standard. However, I believe that the sections covering using the work of others are too restrictive and may lead to a duplication of work between internal auditors and external auditor. In addition, there is no statutory authority or legal intent as a basis for requiring the auditor to perform limited quarterly procedures concerning changes in internal control over financial reporting and section 302 of the Sarbanes-Oxley Act. Furthermore, some clarifications would be beneficial to avoid misunderstandings in the interpretation of the standard by issuers and auditors.

Please find enclosed my comments on the duplication of work performed by management and others, my answers to the Board's 31 questions, and my comments on individual sections of the proposed standard.

I would be pleased to discuss my comments with the Board or its staff at your convenience.

Yours sincerely,

Georg Merkl

Comments on the Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

1. Duplication of work performed by internal auditors and others

Role of and impact on management

As a result of the Sarbanes-Oxley Act, the SEC requires *management* to evaluate the effectiveness of internal control over financial reporting.[1] For most issuers this is a new task that results in a considerable additional effort because they used to delegate this task to their independent accountant. The main reason was that companies thought that the external auditor covered *most* of internal control over financial reporting during his audit of the financial statements and reported on it in his management letter. This personal experience is supported by a survey of the Institute of Internal Auditors.[2] According to this survey over 66,7% of the companies' internal audit departments will increase audits in financial reporting in 2003. In addition, 44,4% of the companies will increase their audit staff in 2003.

In addition, there is a recent trend to increase the independence of internal auditors by having them functionally report to the audit committee. According to two surveys by the Institute of Internal Auditors, the percentage of Chief Audit Executives reporting to the audit committee increased from 55% in 2002[3] to 74% in 2003[4].

Role of and impact on the independent accountant

The registered public accounting firm shall attest to, and report on, the assessment made by the management of the issuer.[5] Management cannot delegate its responsibility to assess its internal controls over financial reporting to the independent accountant.[6] This wording by congress and the SEC already implies that the independent accountant evaluates and uses the work of management and others.

Overlap and potential duplication of work

As a result, we have a situation where one type of professional independent auditors, the internal auditors, have to audit internal control over financial reporting, and another type of professional independent auditors, the external auditors, have to audit the same area. In other words, we have a new significant overlap of the work of internal auditors and external auditors that did not exist in this magnitude before the

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[1] 17 CFR 240.13a-15(c) and 17 CFR 240.15d-15(c)
[2] The Institute of Internal Auditors, Impact of Sarbanes-Oxley on Interal Audit, February 25, 2003, http://www.gain2.org/soasum.htm, question B1a and question B4
[3] The Institute of Internal Auditors, CAE Reporting Relationships, June 4, 2002, http://www.gain2.org/caereportsum.htm and http://www.gain2.org/finalcaereporting.pdf
[4] The Institute of Internal Auditors, Reporting Lines and Scope of Work, July 6, 2003, http://www.gain2.org/caereporting.ppt and http://www.gain2.org/scopesum.htm
[5] Section 404 (b) of the Sarbanes-Oxley Act of 2002.
[6] Securities and Exchange Commission, Final Rule 33-8238: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Title II., Chapter B., Section 3., Subsection b.

Sarbanes-Oxley Act. The sections of the proposed audit standard, which concern the use of the work of management, and others (sections 103-110) appear to be a change from the flexible risk based approach in SAS No. 65 which has been successfully practised since 1991. In my opinion, the new fixed categories of controls where the auditor should not use the results of testing performed by management and others or where the auditor's use should be limited are not consistent with a risk based and cost efficient audit approach. In addition, I believe the principle that the auditor's own testing must provide the principle evidence for the auditor's opinion is too inflexible. As a consequence, my main concern is that this new fixed approach will result in a duplication of material amounts of work performed by management and internal auditors. Due to the magnitude of the overlap, I urge the Board to examine this issue seriously. I fully agree that the testing performed by management and others should not be taken at face value. However, I believe that a risk assessment as in SAS No. 65 of the work performed by management and internal auditors is a better and more flexible approach to determine the extent of the use of work of management and others. I will elaborate those points in my comments to questions 12-16.

2. Answers to the Board's 31 questions

Q 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 reporting control over financial reporting?

Yes. Footnote 3 is clear and makes sense. If the opinion is on the effectiveness of internal control over financial reporting, then there is no need to make the definition longer and more cumbersome by speaking of the „audit of the effectiveness of internal control over financial reporting". Similarly, an audit of financial statements is not called an "audit of the fair presentation, in all material aspects in conformity with GAAP of financial statements".

Q 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?

Due to the knowledge about the company, inherent risk and control risk that is gained from an audit of internal control over financial reporting, there are economies in the time needed to conduct an audit of financial statements. These economies may also be partially used through intense communication between the audit team members conducting the audit of internal control over financial reporting and the audit team members conducting the audit of financial statements.

While I see no compelling reason for such a prohibition, section 404 of the Sarbanes-Oxley Act of 2002 clearly states "each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. … Any such attestation shall not be the subject of a separate engagement". Therefore, I think it was congress' intent that the auditor should be prohibited from performing an audit of internal control over financial reporting without also performing an audit of the financial statements.

Q 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?

The auditor need not be required to also complete an audit of the financial statements. However, there should be an obligation for the auditor to use the knowledge about the company, inherent risk and control risk that is gained from an audit of internal control over financial reporting during his audit of financial statements. This knowledge may be obtained through assigning one or more members of the same audit team, verbal communication or documentation such as work papers. If this knowledge is not used, there is a duplication of work because the same knowledge is needed to determine the extent of substantive tests during the audit of financial statements. There is a significant overlap between the audit of internal control over financial reporting and the audit of financial statements. Not considering this overlap would be disastrous for the efficiency of the combined audit. This obligation should be mentioned in both, the audit standard concerning an audit of internal control over financial reporting and the audit standard concerning an audit of financial statement.

You may find the following legal intent of the Senate Committee on Banking, Housing and Urban Affairs that inserted section 404 into the bill useful "… the Committee does not intend that the auditor's evaluation be the subject of a separate engagement or the basis for increased charges or fees. High quality audits typically incorporate extensive internal control testing. The Committee intends that the auditor's assessment of the issuer's system of internal controls should be considered to be a core responsibility of the auditor and an integral part of the audit report."[7]

Q 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?

I recommend inserting a company's size as one of the matters that affects the auditor's procedures before the matter industry. I believe that Appendix E is clear and appropriate.

In addition, there should be a reference to the Appendix on small and medium-sized issuers in the sections on documentation (sections 43–47).

Q 5.: Should the Board, generally or in this proposed standard, specify the level of competency 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.

No. I do not think that detailed rules concerning university degrees or a number of years of experience in auditing financial statements can provide an adequate standard. However, there should be a general requirement to evaluate the competence of audit team members during audit planning. Audit team members should only be assigned to tasks for which they are sufficiently competent.

Q 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. The auditor needs to evaluate management's assessment. To do this he needs to reperform a part of the tests of controls done by management and to perform tests of controls (i.e. transactions) not included in management's sample. In addition, if the auditor does not agree with management's assessment of inherent and control risk, he needs to perform further tests of controls.

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

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[7] Senate Committee on Banking, Housing and Urban Affairs, Report of the Senate Nr., Title-by-title-summary of major provisions, Title IV Enhanced Financial Disclosures, Section F. Management assessment of internal controls,

Yes. However, I see no need to include documentation of controls over safeguarding of assets as a separate bullet point. Controls over safeguarding of assets are already included by other bullet points, such as control to prevent or detect fraud and segregation of duties, or controls over relevant assertions related to all significant accounts.

Q 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 the level of significant deficiency or material weakness in internal control?

Yes. It is appropriate that it is just a deficiency and not automatically a significant deficiency or a material weakness.

Section 46 about inadequate documentation of the design of controls is ok. However, there is no paragraph about the consequences of inadequate documentation of the operation/testing of controls. In my opinion, missing documentation can be compensated by the auditor through inquiries and observation of the persons responsible for testing, reperformance of testing according to inquiries and by sample testing.

In general, I propose a different order of the sections on documentation. Section 45, which should describe the purpose of documentation and emphasize that documentation is not an end in itself but just a means to an end, should be placed before section 43 (criteria for contents of documentation).

I also recommend putting section 44 (forms and extent of documentation) after section 45 and before section 43 and to refer to the appendix for small and medium sized companies.

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

Yes. Walkthroughs make sense for really understanding processes and what employees really understand and actually do. This is more pervasive evidence than just reading a written policy or procedure.

Q 10.: Is it appropriate to require the walkthrough be performed by the auditor himself or herself, rather than allowing the auditor to use the walkthrough procedures performed by management, internal auditors, or others?

No. In principle, the auditor should be allowed to use documented walkthroughs performed by management, internal auditors and others. As mentioned in my response to question no. 12, the extent of the use of documented walkthroughs should be based on a risk assessment.

Q 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 auditors use some of the audit evidence

obtained in previous years to support his or her current opinion on management's assessment?

No. To promote audit efficiency, the auditor should be allowed to use some of the audit evidence obtained in previous years to support his or her current opinion on management's assessment. I recommend using a "baseline" audit approach. That means once the effectiveness of a control has been tested, the emphasis should be on tests of significant changes to this control that occurred later. If an application control in the accounting system (e.g. SAP) that provides a three-way-match has been audited in the first year, only a check, whether customizing tables or master data tables, which relate to the three-way-match, have been changed, should be required. However, due to the Use of Professional Scepticism in section 111, there should be at least a limited (i.e. a smaller sample than the first year) reperformance of tests of manual controls because the same employee could have become complacent, distracted or otherwise not carry out his or her responsibilities.

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

The extent should not be determined by fixed categories of control, but by an assessment of inherent risk and control risk as in SAS No. 65. Inherent risk is mostly based on materiality, which is in turn based on the amount, its subjectivity (degree of estimates and judgements required) and the probability of a misstatement. Control risk is based on the competence and objectivity of management and others (e.g. internal auditors) and the quality and effectiveness of the work (i.e. tests of controls) performed by management and others.

Consequently, there is a sequential approach for determining the extent of the work of others:

1.) Assess inherent risk. The result of this assessment has an impact on the extent of the sample size for tests of controls.
2.) Assess the competence and objectivity of management and others (e.g. internal auditors). The result of this assessment has an impact on the extent of the sample size for tests of controls.
3.) Assess the quality and effectiveness of the work of management and others by assessing their assessment of inherent and control risk, the result of the assessment has an impact on the sample of the tests of controls performed by management and others that needs to be reperformed by the auditor and his sample of tests of controls which were not included in the sample selected by management and others. If the auditor does not agree with management and other's assessment of inherent and control risk (i.e. their sample size) or does not agree with their objectivity (i.e. believes they have deliberately selected a "clean" sample to be presented to him), he should increase the sample of tests of controls which were not included in the sample selected by management and others.
4.) Assess the quality and effectiveness of the work of management and others by reperforming a sample of the tests of controls performed by management and others and by performing tests of controls, which were not included in the sample of management and others.

I recommend to explicitly include this sequential approach and to include more language and tests from SAS No. 65 or more references to SAS No. 65 which already uses risk based approach.

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

No. As I mentioned in my response to question nr. 12, I believe that a risk based approach is better than the fixed three categories of controls.

The proposed standard does not disclose reasons why the auditor should not use the results of testing performed by management and others in the category of controls described in section 104 or why his use of testing of should be limited in the category of controls described in section 105 of the proposed standard. Possible reasons could be a general distrust of management's or the internal auditors' independence or a general distrust of the competency of management's or the internal auditors in complex financial accounting issues.

In general, I do not see a reason why work performed by an internal auditor who has been assessed to be competent and objective by the auditor should not be trusted. In addition, even the work of management and others should be trusted if the auditor has assessed the whistleblower controls to be effective.

If internal audit reports directly to the audit committee and if effective whistleblower procedures have been implemented that allow employees to report suspected fraud to the audit committee, I see no reason why the auditor should not use the testing of internal audit of controls specifically established to prevent and detect fraud. In addition, a lot of the controls that are part of the control environment are "soft controls" which relate to employee perceptions. Those controls are typically tested through employee questionnaires. The analysis of those questionnaires and the communication of conclusions to the audit committee can also be effectively performed by internal auditors.

Furthermore, I see no reason why testing of controls over the period-end financial reporting process performed by internal auditors that are competent in financial reporting and IT should not be relied upon in principle. In modern ERP systems, transaction totals do not need to be entered into the general ledger manually. A posting of a transaction to a subledger is automatically posted to the general ledger in the same posting because the database record of the posting contains both a field for the account nr. in the subledger and a field for the account number in the general ledger. In addition, most consolidating adjustments are automated through partner intercompany codes in consolidation systems.

Moreover, IT auditors of internal audit are competent to assess information technology general controls on which the operating effectiveness of other controls depend. They may even be more qualified than the external auditor because of their in-depth knowledge of the IT systems and their customisation by the company. The same ERP system can be customized quite differently at different companies. As a consequence, it is harder for the external auditor to know the customizing at each client than for the internal auditor to only know the customizing at his company.

I find it hard to see why a walkthrough that was documented by internal auditors in sufficient detail should not be used by the auditor if the conclusions drawn form the walkthrough that were used to determine the size of the sample tested by internal auditors are also properly documented. A walkthrough can be quite time consuming. Its main purpose is to gain an understanding of the design of controls and its understanding by employees.

In addition, if the competency of an internal auditor in financial accounting has been assessed as high, the auditor should be able to fully use the work of internal auditors concerning accounts involving significant judgments and estimates because they are qualified to challenge management's judgments and estimates and can report disagreements to the audit committee in the same way the auditor could.

Q 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?

Yes. Section 108 gives appropriate recognition to the work of internal auditors.

I propose to place section 107 on preconditions to using the work of others and section 108 on internal auditors directly after section 103 to emphasize the risk based approach.

Q 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)?

No. As I mentioned in my responses to questions no. 12 and 13, fixed categories of control do not offer an appropriate flexibility in determining the extent of reperformance of the work of others. I recommend that the standard explicitly requires the auditor to reperform a sample of the tests of controls selected by management and others and to perform a sample of tests of controls not selected by management and others, but that it does not require a fixed sample size.

Q 16.: Is the requirement that the auditor to obtain the principal 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?

No. I am concerned that this requirement may be interpreted to mean to require reperformance of the majority of the sample of the tests of controls performed by management and others or as an excuse to increase audit fees. However, as in SAS No. 65, I agree that the auditor retains the final responsibility for his opinion and the extent of the use of the work of others and the audit risk is his judgment.

Q 17.: Will the definitions of the proposed standard of significant deficiency and material weakness provide for increased consistency in the evaluation of deficiencies? How can the definitions be improved?

Yes. I think so. However, the definitions of significant deficiency and material weakness need interpretation and will always be subject to professional judgement.

Q 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?

No. In my opinion, the examples in appendix D need to be improved to provide helpful guidance.

Example D-1 is not good because it relates to intercompany transactions. Materiality is considered based on consolidated amounts. Intercompany amounts get eliminated by consolidation. They primarily relate to balance sheet activity and their effect is an increase or a decrease in assets or liabilities. As a consequence, only non-reconciling intercompany amounts can have an effect on the consolidated amounts. In addition, it does not explain why the amount is significant and not inconsequential. It only mentions a significant number of transactions and that the individual transactions are not material but not why the combination of the two results in an amount that is significant. I recommend more details in this example.

There is no explanation in example D-2 why a change in shipping terms can cause a delay in revenue recognition. The new shipping term would need to be a shipping term that transfers the significant risks and rewards of ownership to the buyer after the time of shipment from the seller's warehouse/premises. E.g. CIF port of destination in order to cause a change in the timing of revenue recognition. Again, I recommend more details in this example

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

Yes it is necessary to evaluate the severity of all identified internal control deficiencies. I think that this evaluation is the basis for the auditor's judgement if the deficiency is a significant deficiency, a material weakness or just a deficiency.

Q 20.: Is it appropriate to require the internal auditor to communicate all deficiencies (not just material weaknesses and significant deficiencies) to management in writing?

Yes. Material weaknesses and significant deficiencies should be communicated to management and the audit committee. All other deficiencies should only be communicated to management. Since there is an evaluation whether something is a deficiency or nothing at all, I do not see a problem there.

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

Yes, I think so.

Q 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. I believe that investors would be very interested to read about the non-effectiveness of the audit committee's oversight in the audit report.

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

Yes. I think they will be able to carry it out trough interaction with the audit committee, inquiry and reviewing documentation. However, there may be an independence problem for the auditor since he gets appointed and compensated by the audit committee.

Q 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. I believe that issuing an adverse opinion and disclosing the material weakness provides more relevant and timely information to investors than simply withdrawing from the engagement.

Q 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?

Yes. Consistency with the required management report is important in order to not confuse investors.

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

That depends if public disclosure of significant deficiencies is intended.

Q 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?

Yes. This is more meaningful to investors.

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

Yes. Guidance on internal control-related non-audit services would be useful. E.g. general Sarbanes-Oxley training. Help in documenting controls. Help in management's self assessment (which is effectively internal audit). However, giving advice how much documentation is likely to be needed for the audit should be permitted.

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

Internal audit services and internal control consulting services should be prohibited as required by the Sarbanes-Oxley Act. However, it should be permitted that the client can ask his auditor about his understanding of how to apply rules and regulations on internal control. This is an important element of the coordination between the client and his auditor to preempt later problems due to a different interpretation/opinion of the auditor.

Q 30.: Are the auditor's different levels of responsibility as they relate to management's quarterly certifications versus the annual (fourth quarter) certifications, appropriate?

The auditor attests to Management's assessment of the effectiveness of the registrant's internal control over financial reporting as of the end of the registrant's most recent fiscal year contained in management's annual report on internal control over financial reporting required by Item 308 (a) of Regulation S-K, but not to management's certification required by section 302 of the Sarbanes-Oxley Act and not to the disclosure of changes in internal control over financial reporting required by Item 308 (c) of Regulation S-K.

In my opinion, there is no statutory authority and legal intent to require limited audit procedures for internal control over financial reporting for quarterly reports. Section 404 (a) of the Sarbanes-Oxley Act states that "The Commission shall describe rules requiring each *annual* report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 USC 78m or 78o(d)) to contain an internal control report …" (emphasis added). To me it seems congress' intent was to only have an *annual* audit of internal control over financial reporting. In addition, section 302 of the Sarbanes-Oxley Act does not require management's certifications to be audited. Furthermore, the registered public accounting firm's attestation report that is required by Regulation S-K Item 308 (b) only refers to Management's annual report on internal control over financial reporting required by Item 308 (a) and not to the disclosure of changes in internal control over financial reporting required by Item 308 (c). Consequently, there is also no statutory authority and legal intent to audit the disclosure of changes in internal control over financial reporting.

As a consequence, I recommend removing "and the auditor" from footnote 20 to section 151 and removing the sections 183-189 (Auditor's Responsibilities for Evaluating Mangement's Certification Disclosures About Internal Control Over Financial Reporting).

If management discovers a material weakness in internal control during the year and fixes it before the end of the year, the auditor should only be required to audit the effectiveness of the fixed control. If it is effective, management is allowed to conclude that internal control over financial reporting is effective as of the end of the year.

Although the auditor's opinion on the effectiveness of internal control over financial reporting is *as of the end of the year*, he will also need to make tests of controls *during the year*, but for purposes of expressing an opinion on the fair presentation of financial statements in conformity with GAAP.

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

No. Please refer to my answer to question 30.

3. Comments on individual sections of the proposed audit standard

Section 13 (Committee of Sponsoring Organizations Framework)

The standard should explicitly mention the other frameworks mentioned in the SEC's final rule 33-8328 as examples of suitable frameworks (i.e. Assessing control/Criteria of Control by the Canadian Institute of Chartered Accountants and Turnbull by the Institute of Chartered Accountants of England and Wales) in section 13.[8]

Section 14 (Committee of Sponsoring Organizations Framework)

I think it is potentially misleading to use the term "accounting controls" in section 14 because it may be confused with "internal accounting controls" which is the old term for "internal control over financial reporting". If controls typically performed by the accounting department are meant, then they should be called so. A lot of controls which are typically performed by other departments than the accounting department materially affect financial reporting (e.g. a review of overdue open purchase orders by the purchasing or receiving department may reveal that goods receipts for shipments have not been posted and that inventories and liabilities are misstated; a review of overdue open production orders by the production planning department may reveal that production progress confirmations have not been posted and that work-in-process and expenses are misstated, reports by the legal department may be the basis for estimates for provisions for liabilities linked to lawsuits and for disclosures about open and terminated lawsuits).

Section 15 (Inherent Limitations in Internal Control over Financial Reporting)

I recommend including the concept of a cost-benefit-balance, which is linked with the concept of *reasonable* not absolute assurance, as one of the inherent limitations in internal control over financial reporting (see Internal Control – Integrated Framework Executive Summary, page 3) in section 15. There are cases when the cost of a control is prohibitively high compared to the risk of misstatement. It is important to avoid the perception that controls are an end in itself instead of a means to an end.

Section 24 (Fraud Considerations in an Audit of Internal Control Over Financial Reporting)

Section 24 speaks of the "prevention, identification, and detection of fraud". What is the difference between identification and detection? This seems duplicative and may be confusing. I recommend removing "identification". Similarly eliminate "deter" in section 25 since both preventive controls and the knowledge of the existence of detective controls act as a deterrent.

Section 50 (Obtaining an Understanding of Internal Control Over Financial Reporting)

[8] SEC Final Rule 33-8328, S. 93, footnote 67 in chapter II, section B, 3.a, http://www.sec.gov/rules/final/33-8238.htm

To me, the meaning of "For the purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained for the financial statement audit" in section 50 Control is somewhat unclear. Does it mean that control activities that were not considered in a financial statement audit because the time to test those controls was not justified by the time saved by reduced substantive tests under previous AICPA audit standards? I believe this is a general principle and that the sentence should be removed from this specific section and moved to another more appropriate section.

In addition, I recommend to move the last sentence in the Information and Communication bullet point to the end of the Control Activities bullet point. Controls over the safeguarding of assets, the processes for authorization of transactions, the maintenance of records and the period-end financial reporting process are part of the control activities element rather than the information and communication element of internal control.

Section 99 (Timing of tests of controls)

I think the need for an evaluation of superseded controls depends on the interpretation of investors and the PCAOB whether the concept of concluding on the effectiveness of internal control over financial reporting as of a certain date only applies to this point in time or applies to a time period. In any case, I strongly recommend adding "However, the auditor needs to evaluate superseded controls for the purpose of expressing an opinion on the financial statements because ineffective superseded controls may have caused material misstatements in the financial statements.".

Section 144 (Effect of Substantive Procedures)

I recommend an addition to section 144 that would provide further clarification. Substantive procedures at a certain point in time give assurance that the output of a process was correct at that point in time. However, the reason for this may have been pure luck that existed at this point in time and not due to effective controls in the process. Only a test of the design and operation of controls can provide reasonable assurance that controls are effective to provide reasonable assurance that the process results in a correct output.

Appendix C Safeguarding of Assets

I recommend including decisions to incur expenditures at prices that prove not to be the best price, in addition to decisions to incur expenditures for unnecessary, unsatisfactory or unproductive goods in section C3. It may be beneficial to start section C3 with the fact that the concept of safeguarding of assets does not include controls over bad management decisions that decrease existing and newly acquired assets as long as they are processed correctly in the accounting records.

It is important to define if controls to prevent or detect fraud that involves sales at unauthorized prices or expenditures at prices which are higher than prices of other bidders with or without kickbacks to company employees (i.e. sharing a part of the misappropriated assets) are included in the definition of safeguarding of assets and the audit of internal control over financial reporting. Since controls over competitive bidding to prohibit procurement fraud are very time consuming and expensive, I wonder where the line for reasonable assurance should be drawn. If expenditures for outgoing freight are high due to a purchasing fraud, does this result in a misstatement of the financial statements? In a way the money has been spent on freight, but part of it was unnecessary. I believe if the fraudulently gained amount is significant, there is a material misstatement of the financial statements, because investors would be interested in a footnote disclosure how much was due to the fraud and will be non-recurring in future years. However there is still a cost-benefit dilemma for the company, its internal auditors and the external auditor. I guess ratio-analyses and trend analyses which show indicators for fraud could be cost-efficient.

MGIC Investment Corporation

Gary A. Antonovich
Vice President - Internal Audit

November 19, 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

We are pleased to comment on the proposed auditing standard - *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* proposed in PCAOB Release No. 2003-017. We are only responding to those questions asked by the PCAOB within Release No. 2003-017 that we have substantive comments on.

Questions

#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?

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

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

#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?

Comments

- Paragraph 104 of the proposed standard states that the auditor should not use the results of testing performed by management and others for the following areas: 1) controls that are part of the control environment; 2) controls over the period-end financial reporting process; 3) 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; and 4) walkthroughs. We believe that auditors should be allowed to use the results of others

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(especially internal auditors) in these areas, the extent of which would be based on an evaluation of the factors included in paragraph 103 of the proposed standard. In addition, paragraph 103 should be expanded to include an evaluation of the competence and independence of the party performing the testing.

- We believe that the areas defined in paragraph 104 are significant areas requiring extensive auditing procedures. Providing auditors with no flexibility in using the work of others in these areas may lead to excessive auditing costs.

- Other than the above comments, we believe paragraph 108 of the proposed standard provides proper recognition to the work of internal auditors.

- We believe that the Board should clarify the requirement in paragraph 109 that states "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" (e.g., greater than 50%).

Question

#11 - Is it appropriate to require the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year or may the auditor use some of the audit evidence obtained in previous years to support his or her current opinion on management's assessment?

Comments

We believe that the auditor should be allowed to use risk assessment to determine whether controls for all relevant assertions for all significant accounts and disclosures should be evaluated every year. We do not believe that all significant accounts and disclosures should be treated equally. Controls associated with certain accounts and disclosures may require annual assessment based on the potential risk of misstatement; however, we believe that other controls may not require annual assessment based on an evaluation of certain risk factors, such as the risk of misstatement, the results from prior assessments, changes in control procedures and personnel since the last assessment, and whether the control is routine/systematic. We believe requiring testing of controls for all relevant assertions for all significant accounts may be unnecessary and may lead to unnecessary auditing procedures and related auditing costs.

Questions

#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?

#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?

#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?

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

Comments

- We believe that it is important for the standard to provide definitions that will lead to increased consistency in the evaluation of deficiencies. We also agree that the significance of a deficiency should be evaluated based on the potential "likelihood" of a misstatement and the potential "amount" of a misstatement. However, we believe that the definitions included in the proposed standard set the bar too low for determining whether a deficiency is a significant deficiency or material weakness. We specifically disagree with the use of "more than a remote likelihood" in the definitions of significant deficiency and material weakness, and the use of "more than inconsequential in amount" in the definition of significant deficiency. For a deficiency to be considered significant or material, we believe that the potential likelihood of a material misstatement should be significantly more than remote (e.g., likely or probable). We also believe that for a deficiency to be considered significant, the potential misstatement should be significantly more than inconsequential in amount (e.g., significant).

- Based on these current definitions, we believe that it could be misleading to investors if management is required to conclude that controls are not effective and auditors are required to issue an adverse opinion when a single material weakness exists. This could lead to an unnecessary decline in shareholder value.

- We do not believe that auditors should be required to report all internal control deficiencies to management in writing. We believe that reporting of significant deficiencies and material weaknesses in writing is sufficient. Communication of deficiencies between management and the auditor should focus on significant matters so that management understands what is important and what should be corrected in a timely manner. The auditor should be allowed to communicate lower risk deficiencies verbally, or in some cases be able to pass on small matters entirely. If reported in writing, management may feel compelled to correct all deficiencies reported, even though certain deficiencies may not warrant correction based on a low level of risk and the costs required to correct the deficiency.

- We believe that the auditor may have difficulty conducting an unbiased, effective evaluation of the audit committee since the auditor is directly accountable to the audit committee.

Additional Comments

- Appendix B of the proposed standard addresses situations when a company uses a service organization. We believe that obtaining evidence regarding the effectiveness of internal controls over financial reporting at service organizations will present a significant challenge to companies and their auditors. Many service organizations may not have a service auditor's *report on controls placed in operation and tests of operating effectiveness* available, or the report may not be available prior to the date of management's report on internal control over financial reporting. Requiring companies to perform tests of controls at service organizations will place significant burdens on companies and their auditors, and on the service organizations themselves.

- Another concern relates to how a company should report a material weakness at a service organization. Is it reasonable for a company to be required to conclude that their internal control over financial reporting is not effective due to a material weakness at a service organization that they have no direct control over? Will all clients of that service organization be required to come to the same conclusion? What if one client of the service organization discovers the weakness during their test procedures but another client does not, resulting in inconsistent assessments? We believe the Board should reconsider its position regarding a company's and its auditor's responsibilities for assessing controls at a service organization.

I would be happy to discuss these comments with the Board and can be reached at 414-347-6918.

Very truly yours,

Gary A. Antonovich

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November 21, 2003

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

RE: PCAOB Rulemaking Docket Matter No. 008

Ladies and Gentlemen:

Microsoft appreciates the opportunity to comment on the proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. We support independent auditor involvement in attesting and reporting on management's assessment of the effectiveness of internal control over financial reporting, but believe the proposal goes far beyond that envisioned under Section 404(b) of the Sarbanes-Oxley Act. In particular, we do not believe the proposed definitions of significant deficiency and material weakness are consistent with the definition of internal control over financial reporting, which is defined as "a process . . . to provide **reasonable** assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes . . ." [Emphasis added]. Given this inconsistency and the importance of full, thorough and careful consideration of this important point, Microsoft believes it is incumbent on the PCAOB to work with the SEC to extend the effective date of the internal reporting and disclosure requirements of Section 404 of the Sarbanes-Oxley Act until fiscal years ending on or after December 15, 2004 for companies that are accelerated filers. In addition, we believe certain aspects of the proposed Auditing Standard unnecessarily increase the cost of compliance and the requirement that the external auditors evaluate the effectiveness of the audit committee is undesirable for several reasons.

The proposed Auditing Standard defines a material weakness as "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". The definition of significant deficiency also includes the term "remote likelihood" and the proposed Auditing Standard indicates that it has the same meaning as the term "remote" as used in FAS No. 5. Based on this guidance, the definition of a material weakness can be understood to mean "a significant deficiency that, . . . results in more than a slight chance that a material misstatement of the annual or interim financial statements will not be prevented or detected". We believe this is a significant change from the current definition of material weakness included in

Statements on Standards for Attestation Engagements No. 10. SSAE No. 10 says that a material weakness is "a 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 may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions".

Given that the both the proposed Auditing Standard and SSAE No. 10 describe internal control over financial reporting as a process providing reasonable assurance, we are having difficulty understanding why the proposed Auditing Standard contains such a significant change in the definition of a material weakness, from a "relatively low level" to "slight chance" that a material misstatement will not be prevented or detected. This is an especially pressing issue for Microsoft, as we have a June 30 fiscal year-end and are currently in the midst of our internal control assessment, documentation and test work. As indicated in SEC Release No. 33-8238, SSAE No. 10 is the standard applicable on a transition basis for attestations required under Section 404 of the Sarbanes-Oxley Act and we believe it is only fair that the effective date of the internal reporting and disclosure requirements of Section 404 be extended so that sufficient time is available for companies to understand the final Auditing Standard and properly apply it. This includes executing tests of critical quarter-end controls, which we do not believe the proposed Auditing Standard provides sufficient time to complete given the compressed timeframe from a final rule to the currently proposed effective date. Microsoft recommends an effective date of fiscal years ending on or after December 15, 2004 for companies that are accelerated filers.

We also have concerns with certain aspects of the proposed Auditing Standard which we believe unnecessarily increase the cost of compliance, such as the limited level of reliance that the external auditors can place on the work of the internal auditors, the prohibition against external auditors relying on evidence obtained in prior years, and the lack of reliance on mitigating controls that would prevent material misstatements. As drafted, the proposed Auditing Standard seems to equate management testing with that of internal auditors and appears to ignore the unique role of the internal audit function which is implicit in Statement of Auditing Standards No. 65 and reinforced by standards of the Institute of Internal Auditors. In fact, a decrease on the reliance of the work of internal auditors could reduce external auditors' assimilation of internal auditors' considerable knowledge and understanding of an entity's internal controls. The prohibition against rotation of testing ignores the fact that many controls are substantially unchanged from year to year and that they can be validated through sufficient evidence gathering during the planning stage of an audit. We also believe that internal control over financial reporting is a network of controls with multiple levels and that the existence of mitigating or compensating controls should be taken into account.

Finally, we believe the requirement that the external auditors evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is undesirable for several reasons. First, we question whether external auditors have the necessary expertise to evaluate the dynamic nature of an audit committee's roles and responsibilities. We agree that external auditors should consider the role of the audit committee as part of the overall control environment, but requiring the external auditors to evaluate the effectiveness of the audit committee is unwarranted given that a properly functioning audit committee is comprised of individuals with broader expertise than external auditors. Second, having the external auditors evaluate the audit committee risks compromising the quality of the audit committee's oversight of the external auditors. Having the audit committee evaluated by those whom it employs could influence a committee's willingness to assertively manage the external auditor. Third, this requirement would significantly invade the roles and responsibilities of the board of directors by potentially elevating the external auditor's assessment of certain matters over that of the board of directors, with the effect that the external auditors' determinations would supersede that of the board.

If you have any questions, please call me at (425) 722-6514.

Sincerely,

Scott Di Valerio
Vice President, Corporate Controller

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November 21, 2003

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

Re: PCAOB Rulemaking Docket Matter No 008

Dear PCAOB,

We appreciate the opportunity to comment on the proposed standard for the Audit of Internal Control over Financial Reporting. Overall, we believe the draft standard is helpful in clarifying public company and auditor requirements. We're grateful to the PCAOB for their thoughtful consideration of the issues and prompt publication of this draft standard.

Below are our comments and observations for your additional consideration:

1. We fully support the requirement for management to document and test internal controls. However, we believe the proposed standard goes beyond what is necessary to ensure accurate financial reporting. The proposed standard will result in companies focusing a disproportionate amount of time documenting and testing transaction controls when it's the governance and entity controls that contributed to the malfeasance in many companies in recent years. The resulting incremental cost to companies to comply will be substantial and the incremental benefit to shareholders is questionable.

   While we believe the COSO Framework is a good framework for building an effective internal control system, we also believe that management should be able to apply some judgment in designing the internal control system within that framework. Emphasis should be placed on effective risk assessment processes and a robust system of internal controls over key risks as determined by management.

2. The draft standard as written appears to mandate a significant amount of duplicative work. For instance, auditors will be required to perform independent detailed "walk throughs" of each major process with absolute prohibition on using any work of a similar nature already performed by management or internal audit.

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The auditor should be allowed to use judgment to determine how much they can rely on management or internal audit documentation and testing.

In addition, these duplicative reviews are disruptive and costly.

3. The examples of significant and potential material weaknesses provided in the draft are helpful. However, the definition of significant weakness, particularly the term “inconsequential”, is too narrow. Additional guidance should be provided on the definition of significant and material weaknesses including consideration of all relevant compensating controls.

4. The proposal that the auditor evaluate the effectiveness of the Audit Committee presents a conflict of interest since the auditor reports to the Audit Committee. More importantly, the auditor may not have the level of expertise needed to effectively evaluate the audit committee.

In summary, the new rules in Sarbanes Oxley addressing Board Governance, management accountability for financial reporting, and auditor independence rules are appropriate regulatory changes that will positively impact corporate governance and protect shareholders. The purpose of Section 404 and the draft audit standard is to improve the effectiveness of the internal controls over financial reporting to further enhance governance processes for the benefit of shareholders. To accomplish this, the standards for companies and auditors should be less prescriptive allowing management, internal auditors and external auditors to exercise professional judgment. A balanced approach of prescriptive rules and professional judgment coupled with management certification of quarterly financial reporting will provide the most effective system of internal controls.

Thank you again for the opportunity to provide comments for your consideration in finalizing this standard.

Sincerely,

Steven J. Strobel
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Office of the Executive Director

November 21, 2003

Mr. William J. McDonough,
Chairman
Public Company Accounting Oversight Board
Washington Office
1666 K Street, NW
Washington, DC 20006-2803

Re: PCAOB rulemaking Docket Matter No. 008
Comments on Proposed Auditing Standard

Dear Mr. McDonough:

A careful review of the Proposed Auditing Standard on auditing internal control of a financial statement audit makes one thing patently clear. The standard requires reliance on the underlying internal control, and on the financial statements. The auditor would be required to understand the systems in place. Then design and test the system, and provide an analysis on the efficacy of that system.

It is fair to state that this is a major initiative for each firm executing this plan. Moreover, it is a major initiative for any Organization that might be subject to the standard. Implementation would create a greater staffing need for both the accounting firm and the Organization to meet the need of adherence to this standard. Consequently, greater costs increase will be passed to the Organization. This will impact management planning initiatives and strategies.

Therefore, we suggest that the standard also require the large public accounting firms to hire smaller minority firms to assist in their performance of the requirements. NABA is convinced that the access to greater markets and the lower cost structure would be very beneficial to all involved. It would also do more toward gaining access to the market place for those Firms that never had the opportunity before. The larger Firms could provide leadership and guidance through oversight review of the work. This is supported by the standard which provides guidance on this issue. Under the section "Using the work of Management and Others" it clearly stipulates that such a practice is acceptable.

The current PCAOB proposed auditing standards will effectively "bundle" Sarbanes-Oxley Section 404 (b) work within the "Big 4" firms. Under contract bundling, large contract awards go to large firms due to the size and complexity of the work requirements. This violates the White House strategy for increasing opportunities for Small Business.
It is only logical to conclude that there is a serious legal problem if "Big 4" firms continue to monopolize the auditing of publicly held companies while being the sole service providers for required

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Office of the Executive Director

assessments of internal control systems. Under Sarbanes Oxley, this action is characterized as self dealing amongst firms. Not to mention that the actions would further weaken the public confidence in financial reporting. The independence and competitive strength of CPA firms performing auditing services for public corporations will be strengthened if Sarbanes Oxley legislation on auditing standards is implemented. Therefore all CPA firms in America must be encouraged to participate in implementing compliance with Sarbanes Oxley.

The current Administration is committed to unbundling procurements that have excluded Small Businesses like minority CPA firms from succeeding in today's market economy. NABA is of the firm belief that concentration of public company audits and related compliance with Sarbanes Oxley within the 4 largest CPA firms in America is detrimental to the strengthening of capital markets. It also a restraint on trade and it creates a false perception of auditor independence.

The Division of Firms of the National Association of Black Accountants has over 50 Member firms that have the experience and expertise to significantly participate in getting America's public companies to comply with the Sarbanes-Oxley Act.

Sincerely,

Darryl R. Matthews, Sr.

Darryl R. Matthews, Sr.
Executive Director and COO

NASBA

National Association of State Boards of Accountancy

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David A. Costello, CPA
President & CEO

November 20, 2003

Public Company Accounting Oversight Board
Attention: Office of the Secretary
1666 K Street, NW
Washington, DC 20006-2803

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

Dear Board Members:

The National Association of State Boards of Accountancy (NASBA) appreciates the opportunity to offer comments to the Public Company Accounting Oversight Board (the Board) concerning the proposed "Auditing Standard -- An Audit of Internal Control Over Financial Reporting Performed In Conjunction With An Audit Of Financial Statements."

NASBA is the national organization of state accountancy regulators. As the only authorities empowered to grant or revoke licenses of certified public accountants (CPAs), the State Boards are interested in the effect that the Board's proposed rules and auditing standards may have upon state public protection programs. We believe that close cooperation and a working partnership of the PCAOB and the SEC with NASBA and the State Boards will result in more effective regulatory efforts than otherwise would be achieved.

Our Professional & Regulatory Response Committee offers the following comments on selected questions posed in Release No. 2003-017:

Question 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?

Comment. Yes, we agree with the Board's integrated approach to the audit of the financial statements and internal controls. The audit of internal controls over financial reporting is complementary to the audit of the financial statements and should be performed by the same firm.

Question 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?

Comment. We agree with your comment that, "For a smaller, less complex company, the Board expects that the auditor will exercise reasonable professional judgment in determining the extent of the audit of internal control and perform only those tests that are necessary to ascertain the effectiveness of the company's internal control." We are concerned that auditors will feel compelled to perform "one-size-fits all testing" resulting in increased costs without increasing the effectiveness of the audit. We believe the standard should provide greater clarity on the importance of the control environment and its potential impact on the level of control testing that should be done. To do this, we suggest that the standard would be enhanced by adding the points enumerated in Appendix E Section E1 to the body of the standard.

Question 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.

Comment. We believe that general guidance would be helpful to auditing firms without mandating specific training requirements. Further, we believe that the facts and circumstances of each engagement will dictate the amount of training that a particular team should have. The use of professional judgment by the firm to meet the circumstances of the engagement should be emphasized. We believe this is in harmony with the Uniform Accountancy Act.

Question 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?

Comment. We agree that the auditor should be allowed to evaluate the severity of the lack of documentation and its effect on internal control. While proper documentation is an important part of the control environment, the existence or lack of internal controls, not the lack of proper documentation, should ultimately form the basis for the auditor's report on internal controls.

Question 10. Is it appropriate to require that the walkthrough be performed by the auditor himself or herself, rather than allowing the auditor to use walkthrough procedures performed by management, internal auditors or others?

Comment. We believe that the cost and benefit of any regulation must be carefully evaluated. We believe that any perceived benefit of allowing only the auditor to perform the walkthroughs is outweighed by the cost. When the internal audit function is properly structured as a quasi-independent organization within the company, reporting through appropriate channels, it can be a powerful tool in the control environment. To prohibit the use of internal auditors in performing or assisting with walkthroughs when properly supervised and retested by the external auditor is inefficient. It may also force the external auditor to deploy resources on more mundane areas to the detriment of the audit of riskier areas, thus decreasing the overall effectiveness of the auditor.

Again, we believe that the standard should allow for professional judgment in determining reliance upon the work of others. We believe that the standard should encourage the use of internal auditors and the use of internal audit in public companies.

A substantial percentage of accountancy boards' licensees are employed by corporations and are bound by the same code of professional conduct as the licensees in public practice. In fact, many are hired because they are CPAs.

Question 11. Is it appropriate to require the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year or may the auditor use some of the audit evidence obtained in previous years to support his or her current opinion on management's assessment?

Comment. As previously indicated, we believe the audit of internal controls should be thorough and complete but should also be efficient and cost effective. In many organizations, especially those that are well-controlled, the control environment may change little from year to year. In those environments, the auditor should be able to use his or her professional judgment and audit knowledge gained from prior years to determine the scope of the work to be performed. We are not suggesting that significant areas be skipped or rotated from year to year, but the level of audit testing may be varied from year-to-year to allow emphasis or focus on a variety of areas.

Question 12 . To what extent should the auditor be permitted or required to use the work of management and others?
Question 13. Are the three categories of controls and the extent to which the auditor may rely on the work of others appropriately defined?
Question 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?

Comment. As indicated in our response to Question 10, we believe that the work of internal auditors should be permitted subject to the external auditor's evaluation that the work of the internal auditors can be relied upon. Similarly, we believe that work performed by management can be used when properly tested by the external auditor and under the appropriate circumstances, for example, in routine processing areas.

Further we believe the three categories specified are appropriate. However, we believe that the prohibitions outlined in the last two bullet points in paragraph 104 do not give due consideration to the use of the results of testing performed by others. Using professional judgment and appropriate retesting, the external auditor should be allowed to use the work of management and others in these areas subject to independence considerations. For example, IT experts may enhance the audit by providing very valuable assistance in testing information technology controls.

Question 17. Will the definitions in the proposed standard of significant deficiency and material weakness provide for increased consistency in the evaluation of deficiencies? How can the definitions be improved?

Comment. We are concerned that the use in paragraph 8 of the term "remote" coupled with a new term "inconsequential" could result in too broad a definition of significant deficiency. Using this broad definition could result in somewhat trivial items being reported to the audit committee, thus diverting the audit committee from evaluating truly important items. We believe that the auditor should exercise professional judgment, focusing on items that could result in significant misstatements if not corrected.

Question 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?

Comment. Auditor judgment should be allowed to determine which deficiencies need to be reported in writing. The auditor should not be required to report insignificant items. This will help management focus their corrective efforts on significant areas.

Question 22. Is it appropriate to require the auditors to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting?

Comment. The auditor should not be required to evaluate the audit committee. This creates an unworkable conflict-of-interest as the audit committee is charged with engaging the outside auditor and approval of additional services. We believe that the company's board of directors has the responsibility to evaluate the effectiveness of the audit committee. In making that evaluation they can solicit factual information from the auditors to help them in that assessment. However, if the auditors, in the course of their dealings with the audit committee, become aware of problems in the operation of the audit committee that are significant to the internal control structure of the company, they should be reported to the board of directors.

Question 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?

Comment. We believe that a material weakness that is identified and then corrected in sufficient time before the date of the auditor's report on internal controls to allow additional testing to make sure it is operating effectively, should not result in an adverse report on internal control.

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

Comment. We believe that an "except for" opinion may be appropriate in limited circumstances, for example, a recent acquisition. If the Board determines that an "except for" opinion may be appropriate, we suggest that examples be given to clarify under what circumstances it may be used.

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

Comment. Consistent with the philosophy that the auditor should not audit his or her own work, we believe that the auditor should not develop the internal control structure and then perform an audit of internal controls. Another firm should be engaged to help management design and implement internal controls.

NASBA is pleased to provide these comments and would be happy to answer any specific questions you might have.

Sincerely,

David A.Vaudt, CPA
Chair

David A. Costello, CPA
President & CEO

National City

National City Corporation
National City Center
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James P. Gulick
Senior Vice President
General Auditor

November 14, 2003

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

Reference: Rulemaking Docket Matter No. 008

Gentlemen:

We are pleased to submit our comments on the proposed auditing standard over the examination of internal controls. Having reported under the requirements of the Federal Deposit Insurance Corporation Improvement Act for the past 10 years, we understand the breadth and depth necessary to document and test an internal control environment. Our overall sense of the proposed auditing standard is that it is very comprehensive and should result in improved documentation and operation of internal controls. The focus of our comments in this letter are on the testing of controls, the use of internal audit, and the extent of documentation and testing required of the external auditor. The responses are organized using the questions outlined in the exposure draft.

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

Q.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?

We believe the use of a walkthrough is a critical step to ensure that controls are properly understood and documented. This step has been a requirement of our internal audit process for many years and is effective in ensuring that the internal control system is accurately documented. We believe the requirement for the external auditor to directly perform the walkthrough test in order to comply with the auditing standard is excessive and unnecessary. Presuming the Corporation has an effective internal audit group and conforms to professional standards such as those published by the Institute of Internal Auditors, the internal auditors' working papers will contain system documentation, walkthrough testing, and audit testing of the controls. Further, management will also have documentation of its control system. The external auditor should be able to obtain sufficient satisfaction with the documentation of the control system by reviewing said documentation and the results of both the walkthrough and audit testing performed by internal audit and reperforming a sample, as is currently required under SAS 65. Presuming the results of those tests are adequate, the reperformance of every walkthrough is redundant. Further, as the years pass by, the walkthrough becomes redundant for internal control systems that do not change. Thus, the mandate for a walkthrough every year by the outside auditor is cost inefficient as well. We believe the walkthrough should be required to be performed by the outside auditor only on a test basis or in those circumstances where the auditor's reliance on the work performed by internal audit cannot be comfortably attained, or the outside auditor believes there are weaknesses in the control system or inaccuracies in the documentation.

Q.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?

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

Clearly the external auditor needs to perform enough work to satisfy himself that controls are in existence and operating during the period under audit. Thus, some level of new testing will be required every year. However, for control systems that do not change significantly from year to year, the external auditor will have developed a foundation upon which he can build his audit testing in the subsequent year. The auditor should be given the flexibility to rely on prior year systems documentation, walkthrough testing, and the results of prior year testing to determine the extent of testing needed in the current year. If an internal audit department is performing ongoing testing and assessment of internal controls, the external auditor should have the flexibility to rely on that work to reduce the amount of new testing required in any year. This would include providing the external auditor the ability under the rules to determine that no new original testing need be performed by the external auditor if he is totally satisfied with the results of the internal auditing and the system documentation that exists. Generally speaking, this reliance should be based upon a positive result of a continuous monitoring program that the internal audit department is independently performing over the control environment.

In order to form an opinion on the internal control system, some level of independent testing is necessary. For a corporation where internal audit activity is minimal or non-existent, the external auditor would need to perform extended testing in order to gain the appropriate coverage and comfort over the control environment. Clearly, any management testing that is performed can be tested by the external auditor and serve to reduce the overall testing level of the external auditor if the management testing is determined to be accurate. However, given that management is responsible for the operation of the controls, sufficient independent testing is appropriate. However, for organizations that have invested in a competent internal audit department with robust internal audit testing, the external auditor should be able to limit his work by testing the work of the internal audit department. The internal auditor is already charged with providing an independent assessment of the operation of the internal controls. Thus, the external auditor should be able to rely upon that work to limit and reduce the level of original work performed by the external auditor. Ultimately, the external auditors extensive original testing should be focused on potential weaknesses in the control system or areas where management or the internal audit department have not performed adequate testing.

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

While the intent of the audit standard appears to be giving the external auditor some flexibility, there are certain phrases in the standard that are confusing and somewhat contradictory, as follows:

- Paragraph 104, bullet 1 states that "...the auditor should not use the results of testing performed by management and others, including **controls that are part of the control environment**..." This statement is confusing. It would appear this bullet is intended to be the counterpart to paragraph 105, bullet 2 where the auditor has the option to rely on the work performed by management or others for control areas that are deemed highly likely to operate effectively. While it is apparent that the objective is to provide an opportunity for the external auditor to utilize professional judgment, we aren't sure how these two bullets working together provide a framework for the auditor to make a decision within the context of the audit standard.

- Paragraph 104, bullet 2 suggests the auditor "...should not use the results of testing performed by management and others, including controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; to initiate, record, and process journal entries in the general ledger; and to record recurring and non-recurring adjustments to the financial statements". While the bullet gives an example referring to consolidating adjustments and report combinations, the verbiage in this bullet can be deemed to refer to all controls for systems that generate mechanized journal entries in support of the general ledger up through the financial reporting process. The bullet does not seem to be restrictive as suggested in the example. Thus, the interpretation of this bullet would suggest the outside auditor could not use the work of others in evaluating controls that result in general ledger entries to record transactions, even though they are routine. This also seems to be in conflict with the item discussed in the previous bullet in this letter.

- Paragraph 104, bullet 3 suggests that the outside auditor cannot rely on any information technology controls that are tested by management or internal auditors. While we acknowledge the critical nature of the information technology control environment, we believe that there are many routine processes within these controls where management or the internal auditors ability to examine these controls is sufficient. The external auditor should have the opportunity to place reliance on the internal audit testing of information technology controls just as it does for non-technology controls.

The proposed audit standard indicates early on that the assertion by the external auditor as to management's assessment of internal controls is equivalent to the external auditors testing of those controls. While we accept and acknowledge that statement, paragraphs 104-106 seem heavily focused on the independent testing of the individual controls. We believe that the external auditor should start from the premise that they are testing management's control evaluation process and that the testing of the auditor should be determined by its ability to gain comfort with management's process. We believe that an audit approach can easily and reasonably be developed where the external auditor can conclude that management's process is effective without the need for extensive new auditing. The auditor should be permitted to start from the "top down" and drill through management's process until they reach a point that they can conclude upon management's assertion, which is equivalent to issuing their own opinion on the system of internal controls. Paragraphs 104-106 suggest that the external auditor is auditing from the "ground up" which in many cases will result in redundant and costly testing to reach the same result.

Q.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?

Q.16 Is the requirement for the auditor to obtain the principal 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?

We believe that the proposed standard does not permit enough emphasis to be placed on the work of internal audit. The auditor's report will focus on management's assertion. Therefore, the preponderance of evidence for the operation of the control environment should rely with management and with management's testing. Only in the case of weak controls or insufficient testing should the external auditor be required to provide the preponderance of evidence to support its audit opinion. These statements presume that the external auditor can obtain a high degree of comfort with the work performed by the internal audit department. The process of documenting and testing the control environment is a time-consuming and costly process. Companies that make the investment in a competent internal auditing department with a robust audit program should be rewarded for that effort by permitting reliance on that work by the external auditor. Alternatively, companies that do not make such an investment should be subjected to intense auditing by the external auditor in order to support management's assertion as to the operation of its control environment. An internal audit department is very likely to have a much more in-depth understanding of a company's operations and controls and therefore its testing should provide a strong foundation upon which the external auditor can rely. While the tone and specific paragraphs of the proposed audit standard suggest flexibility on the part of the external auditor, there is still an obvious requirement that the external auditor perform robust original auditing to support its conclusion. Again, we believe that in situations where controls are strong, documented, and tested that this is a redundant and cost inefficient requirement.

We thank you again for the opportunity to comment on the proposed auditing standard. Please call 216-222-2000 if you would have questions on our comments in this letter.

Sincerely,

James P. Gulick
Senior Vice President
General Auditor

National State Auditors Association

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

Dear Board Members:

On behalf of the National State Auditors Association, we appreciate the opportunity to respond to the PCAOB's proposed auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements.*

Attached are our responses to the 31 questions for which the Board is seeking comments. Also attached are several additional comments on individual sections/paragraphs that we believe the Board should consider as it finalizes this standard.

We appreciate the efforts of the Board and the opportunity to provide our comments. Should you have any questions or need additional information regarding our response, please contact Sherri Rowland of NSAA at (859) 276-1147 or me at (217) 782-3536.

Sincerely,

William G. Holland
President, NSAA

National State Auditors Association
PCAOB's Proposed Standard—An Audit of Internal Control Over Financial Reporting
Performed In Conjunction With an Audit of Financial Statements

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?*

We agree with referring 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. Although some auditors prefer not to use the terms attestation and audit interchangeably, the proposed standard makes clear the objectives of the internal control work to be done. Further, while some auditors may try to draw a distinction between these two terms, the Board, the auditees, and other users of these reports would understand this to be an audit.

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?*

We believe that for purposes of the Sarbanes-Oxley requirements the two items should go hand in hand. However, the wording seems to preclude any additional internal control audits over financial reporting that a company might choose to have performed from occurring. It would seem that in some instances an auditor could audit internal control over financial reporting without also performing a complete audit of the financial statements. At times it seems it would be advantageous to shareholders if a company chose to have additional internal control audits performed. The audit concept should, however, continue to be differentiated from nonaudit services discussed in paragraph 33.

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?*

We do not see the purpose of requiring the auditor to perform work with regard to the financial statements comparable to that required to complete the financial statement audit as an alternative to requiring the auditor to also complete an audit of the financial statements. As noted in the proposed standard, the nature of the work to complete the audit of the financial statements and the audit of internal controls over financial reporting are highly integrated and portions of this standard expect the auditor to consider the results of financial statement audit tests in forming a conclusion about internal controls.

In addition, there are no standards for describing the level of financial statement auditing that is comparable to a financial statement audit, but does not result in a financial statement audit opinion. Lastly, we do not believe an auditor and auditee would want comparable work to be performed without issuing a product to represent that work.

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?*

We believe the proposed standard provides for the appropriate level of testing given the size and complexity of the auditee and would not place small or medium size firms at a disadvantage. However, the proposed standard does not incorporate the Board's expectation that "the auditor will exercise reasonable professional judgment in determining the extent of the audit of internal control and perform only those tests that are necessary to ascertain the effectiveness of the company's internal control." (This quotation is from paragraph immediately preceding Question 4 in the lead-in to the proposed standard.) We believe this should be stated in the standard in the section, *Obtaining an Understanding of Internal Control Over Financial Reporting,* that begins on page A-22.

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.*

We do not believe the Board should dictate the level of competency and training of audit personnel that is necessary to perform specific auditing procedures. Measuring competence and training is highly subjective and based on the individuals, their experience, the composition of the audit team and its assignments, and effective, timely training. If the Board decides to add more specific guidance in the standard about competency and training, we suggest the Board keep the discussion general, perhaps by briefly expanding paragraph 31.

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?*

In order to obtain the necessary level of assurance, the auditor should evaluate management's assessment and directly obtain evidence supporting their conclusions. Satisfying both requirements is necessary because it demonstrates management's responsibility for internal controls and the auditor's responsibility for auditing those internal controls. However, we believe the Board should revise the proposed standard to be clear about what the auditor would do in a situation in which management believes that because of budget constraints or other reasons, it is not cost effective to implement a control and the auditor disagrees or in a situation in which management has not assessed certain controls that they believe are not critical but the auditor believes are critical.

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

We believe it is appropriate for the Board to provide criteria that auditors should use to evaluate the adequacy of management's documentation. Part of the problem the audit industry faces at this point in time is the fact that too many auditors, even with good intent, use the flexible nature of the AICPA standards to justify the nature and extent of tests they perform in such audits. As a result, good auditors, trying to perform good audits, perform widely different levels of tests. More explicit descriptions of the standards' requirements help to improve consistency.

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?*

We believe the auditor should be able to evaluate the level of severity of any such internal control deficiency. The auditor should be able to consider all of the relevant circumstances of inadequate documentation when evaluating to what level any such internal control deficiency rises. Because of the subjective nature of inadequate documentation, and to which internal controls it applies, the auditor will be in the best position to determine the appropriate level of deficiency he or she has found. To mandate this circumstance as significant or material may result in relatively insignificant documentation issues reported with more significant internal control deficiencies.

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

We believe the objectives to be achieved are sufficient to require the performance of walkthroughs. To ensure an understanding of how the system of internal control is designed and operates, the auditor should perform the walkthrough. Too often, auditors rely solely on what management tells them or shows them in written manuals. And just as often, the individuals who perform those procedures, or the procedures used in their place, can be different. In an automated environment, a traditional walkthrough may be difficult to perform so there should be the opportunity for the auditor to achieve the same objectives using alternative approaches if necessary.

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?

Generally, we believe it is appropriate for the auditor to perform the walkthrough to ensure an understanding of what is really happening in an internal control process. However, we believe that if the internal auditor is deemed to be competent and objective, the use of this internal audit documentation could be relied on, but only after verification. We do not believe it would be appropriate to rely on a walkthrough performed by management.

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?

The auditor is responsible, each year, for determining the effectiveness of controls. Since the Board has emphasized that only relevant assertions for significant accounts need testing, and that testing throughout the year is allowable, we believe it is appropriate to require evidence of the effectiveness of controls each year. Although management asserts policies, procedures, and computer controls have not changed, change is inherent. Manual procedures are subject to changes in personnel, changes in existing personnel's behaviors and motivations, and other circumstances. Computer controls are affected by not only changes in programs that directly relate to a process, but also other changes that may indirectly affect a process. Only careful analysis each year by the auditor can determine the effect of any changes to manual or computer controls.

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

We believe the auditor should be permitted, but not required to use the work of management and others. The auditor should have the flexibility to use auditor judgment in determining when to use the work of others. But, without some level of guidance, we believe auditors would vary widely on when they use the work of others and when they would not. We agree with the Board's proposal to describe the types of situations in which auditors cannot, can with limits, and can without specific limits use the work of others. In addition, the auditor should never be required to use the work of others as the sole source of evidence.

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

The proposed categories of controls clearly and consistently explain appropriate reliance on the work of others. It should also provide the auditee's management with areas in which it can determine where it might provide the auditor with opportunities to use others' work, thereby decreasing audit costs.

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?

We do not believe the standard can adequately address all of the possible levels of objectivity that different internal auditors achieve, and the resulting impact on the external auditor's work. Therefore, we agree with the Board's approach of explaining the nature of the internal auditor's potential for more or less objective work. This leaves the professional judgment with the auditor, rather than the internal auditor or the auditee's management, with respect to how much work the internal auditor can or should do to assist in this manner.

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)?

We support the proposed standard's provision to allow the auditor flexibility in determining the extent of reperformance of the work of others. To the extent that the auditor can reasonably verify the competence and objectivity of others performing the work, it is not necessary to reperform or perform additional work as long as the results satisfy the auditor's objectives.

16. Is the requirement for the auditor to obtain the principal 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?

We agree that it is appropriate for the auditor to obtain the principal evidence since it is the auditor that is required to opine on management's assertion. This would help prevent situations in which the auditor's work is primarily (or exclusively) based on the work of others.

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?

We believe the definitions in the proposed standard of significant deficiency and material weakness will provide for increased consistency in the evaluation of deficiencies. The criteria of likelihood and magnitude (paragraph 117), and the descriptions of them included in the proposed standard, provide a sound basis for determining the significance of the deficiency. Also, the additional circumstances listed in paragraph 126 that should be regarded as "at least a significant deficiency" are helpful. However, while the definitions may provide for increased consistency in evaluating deficiencies, the definitions are subjective and auditor judgment will always be a factor in evaluating those deficiencies.

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 examples in Appendix D are helpful and clearly demonstrate how to apply the criteria in evaluating the significance of internal control deficiencies. However, it would be helpful to add examples that address more subjective areas like the control environment and risk assessment.

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

We believe the auditor should evaluate the severity of all identified internal control deficiencies by applying the criteria in paragraph 117 to all deficiencies to determine the appropriate level of significance. Without evaluating all deficiencies, the auditor could not consider the aggregation of deficiencies and whether they rise to a significant level.

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?

We believe that written communication of all internal control deficiencies is appropriate. Given the requirements of management, the auditors, and the audit committees, written communication of all deficiencies ensures each party can fulfill their obligation in this matter.

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

We believe the examples of indicators of material weaknesses are appropriate. However, we believe that in practice, this will not be as clear-cut. There will be instances for which management and its auditors do not agree on the level of severity for certain deficiencies. In those cases, certain of these indicators will be more problematic for the auditor and management to address. For example, significant deficiencies that have not been corrected by management may be the result of management's initial belief that the deficiencies were not significant to begin with. A third party, perhaps the audit committee, will need to be strong in "refereeing" these situations.

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?

We agree that it is appropriate to require the auditor to evaluate the effectiveness of the audit committee's oversight on the company's external financial reporting and internal control over financial reporting. However, the Board should provide additional guidance on what is expected of the audit committee and how the auditor should evaluate the effectiveness of the audit committee's oversight.

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

We believe that with additional guidance provided by the Board, the auditor should be able to effectively carry out their responsibility to evaluate the effectiveness of the audit committee's oversight.

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?

We believe that auditors should issue an adverse opinion rather than be allowed to withdraw from an engagement. Given the increased regulatory nature of the requirements and the overarching concept of providing shareholders information regarding potential problems, it would seem more effective to require the issuance of a report that includes all problems noted by an auditor. This would help preclude an audited entity from being able to shop around for opinions.

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?

Because the Securities and Exchange Commission has already established final rules requiring management to concede that internal control over financial reporting is not effective when a material weakness exists, we believe the auditor's conclusion should be the same (i.e., an adverse opinion). To allow the auditor to issue a qualified opinion, would introduce the potential for misinterpretation or confusion among users of the financial statements.

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

Given our response to question 25, a qualified opinion would not be appropriate.

27. Do you agree with the position that when the auditor issues a nonstandard 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?

We agree that when the auditor issues a nonstandard opinion the auditor's opinion should speak directly to the effectiveness of the internal control over financial reporting. The proposed standard clearly explains the confusion that might occur if the auditor's report that management's assertion is fairly stated, when management has stated that they do not have effective internal controls. In these circumstances, it may appear that the auditors disagree with management's assessment of inadequate internal controls. Reporting directly on the effectiveness of the internal controls provides for clear reporting of the circumstances in the auditor's report.

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

We do not believe that the Board should provide specific guidance on independence in the proposed standard. Rather, we believe the standard should reference to the independence requirements established by the SEC and the Act. When the auditor independence provisions of the Act are fully implemented and evaluated, the Board could then address any weaknesses noted in implementing the Act.

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

Rather than describe, in this standard, specific internal control-related non-audit services the auditor is prohibited from performing, the standard should reference to the standards established by the SEC and the Act. See comments to question 28.

30. Are the auditor's differing levels of responsibility as they relate to management's quarterly certifications versus the annual (fourth quarter) certification, appropriate?

The provisions of the proposed standard regarding the auditor's differing level of responsibility by reporting period are appropriate. By the fourth quarter, if an auditor has otherwise completed the audit, withdrawal from the engagement would seem to be inappropriate if management refuses to make accurate fourth quarter disclosures. Therefore, an explanatory paragraph would allow the auditor to bring the matter to the attention of the SEC and investors.

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

The provisions of the proposed standard regarding the auditor's responsibility for quarterly disclosures are appropriate. To add additional burdens for "auditing" interim disclosures seems unnecessary.

National State Auditors Association
PCAOB's Proposed Standard—An Audit of Internal Control Over Financial Reporting
Performed In Conjunction With an Audit of Financial Statements

Additional comments	
Paragraph	**Comment**
102, first bullet	We are concerned that the first two sentences give the auditors a basis for under-testing automated controls. Because of the complexity of certain transactions and activities, and the resulting variations that can occur in those transactions or activities, the extent of tests of automated controls must be sufficient to determine the controls' effectiveness for each of the possible variations. In those cases, testing only one item for that automated control is not sufficient. Our concern stems from the standard highlighting testing a single item, which we believe auditors will liberally apply to circumstances for which testing only one item is not sufficient.
174-175	Paragraph 174 explains examples of information management might add to its report. However, paragraph 175 provides specific wording that the auditor should use for only one of the examples. If the Board is going to establish that the auditor "should" use this language, then examples should be provided for the language the Board wants the auditor to use in the other examples in paragraph 174. If that is not the intent, the Board should either a) remove paragraph 175's example, b) revise the wording in paragraph 175's second sentence to replace the word "should" with a less prescriptive term, such as "could", or c) generalize the sample wording to say: We do not express an opinion or any other form of assurance on management's statement referring to *(describe the additional information management included).*
176	This paragraph explains what actions the auditor should take to convince the company to remove materially misstated additional information from management's report. However, the Board does not say whether the auditor should say anything in his or her auditor's report about this matter, if the material misstatement remains in management's report. Since the auditor is required to issue an audit report, including an opinion on internal controls, it seems appropriate that he or she also includes a discussion of material misstatements in additional information in an explanatory paragraph. Accordingly, the Board should indicate how the auditor should report such material misstatements, when not corrected by management. If the Board does not believe such auditor disclosure is necessary, it should explicitly state that the auditor has no responsibility to do so, and why.
179	We agree with the guidance provided in paragraph 178, and the auditor's need to report that information. And we agree with the reason set forth in paragraph 179 that users need to understand why the financial statement opinion was unaffected. However, the language provided by the proposed standard does not explain the reason why the auditor issued an unqualified opinion, only that an unqualified opinion was issued. If users need to understand the reasons why, as stated in paragraph 179, the Board should revise the example, or add to its advisory comments in italics, that the auditor should explain why the opinion was unaffected. If this is not the Board's intent, paragraph 179 should be revised to remove the word "why" and replace it with the word "that."
Paragraph 88-110; Appendix B	The discussion in the proposed standard and the Examples of Extent of Testing Decisions do a good job of giving perspective and examples that should help an auditor understand the nature and timing of tests to be performed when evaluating the effectiveness of internal controls. However, the discussion in the proposed standard regarding the extent of tests is brief and does little to give proper perspective about how much is enough to test. Then, the examples use certain sample sizes that create confusion as to the necessary level of the extent of tests. We have been informed all along that performing an audit of internal controls sufficient to opine on the effectiveness of those controls is a higher level of assurance than the extent of tests performed on internal controls in a financial statement audit. However, the discussion in the proposed standard does not reflect that perspective. While it provides some factors to consider, it falls well short of providing auditors with a sound basis for knowing how much is enough. Further, the examples give quite a different impression by suggesting that walkthroughs, testing of one item here, or five periods there, or 25 vouchers, is sufficient to evaluate the effectiveness of certain internal controls. In fact, compared to financial statement audits we perform and the sample sizes we use in our audits' tests of controls, these sample sizes are the same in some cases, and in other cases, less. Even the AICPA's audit sampling guide for financial statement audits provide sample size guidance that suggests sample sizes much larger than the examples provided in the proposed

Additional comments	
Paragraph	**Comment**
	standard. To justify a sample of 25, the AIPCA sampling guide considered an acceptable tolerable error rate in excess of 10 percent, yet the Board's example expected a high level of assurance from testing only 25 items. We believe the major reason for the expectation gap between auditors and the users of audit reports is the extent of work performed. The users always expect the auditors to test more than the auditors do. If the Board expects internal control audits to meet the expectations of SEC intent, investors, and other users, the examples will have to be reconsidered and the guidance in the proposed standard will need to be improved. We certainly do not advocate mandated sample sizes. However, we also believe the current proposed guidance and examples will not close the expectation gap.

NVCA
National Venture Capital Association

January 9, 2004

FILED ELECTRONICALLY

Public Company Accounting Oversight Board
Attention: Office of the Secretary
1666 K Street, NW
Washington, DC 20006-2803
comments@pcaobus.org

RE: PCAOB Release No. 2003-017, PCAOB Rulemaking Docket Matter No. 008, Proposed Auditing Standard – An Audit of the Internal Controls over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

Introduction

The National Venture Capital Association (NVCA)[1] represents the vast majority of American venture capital under management. NVCA member firms and the funds they manage provide the start-up and development funding for innovative entrepreneurial businesses.[2]

VC firms form and manage the funds that invest in start-up and early-stage businesses, commonly referred to as "portfolio companies." Venture capital investing relies on exit strategies whereby venture capital positions in portfolio companies are exited, with the proceeds being distributed to investors. Regardless of the likely exit strategy, portfolio companies operate with minimal staff and a necessarily narrow focus on achieving business objectives – research, market definition, product development, manufacture and sales. Though very few of these venture-backed companies are subject to the Sarbanes-Oxley Act ("SOXA" or "the Act"), as a practical matter, the Public Company Accounting Oversight Board (PCAOB) Rules on auditing internal controls will have a significant impact on them.

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[1] The National Venture Capital Association (NVCA) represents more than 430 venture capital and private equity firms. NVCA's mission is to foster the understanding of the importance of venture capital to the vitality of the U.S. and global economies, to stimulate the flow of equity capital to emerging growth companies by representing the public policy interests of the venture capital and private equity communities at all levels of government, to maintain high professional standards, and to provide research data and professional development for its members.

[2] In 2002, venture capital (VC) funds invested $21.2 billion in 2500 companies, the fourth largest amount ever in the history of venture capital. Eighty-five percent of these companies were in information technology, medical/health or life sciences. The success of venture investing is encouraging greater capital flow to these types of companies. At the end of 2002, VC firms had an estimated $253 billion under management, up from $32 billion in 1990.

Impact of PCAOB on venture capital and entrepreneurship

Successful exits of venture capital investments occur either through an initial public offering ("IPO") or through acquisition by another company, often a public company. A company in a pre-IPO, or a pre-acquisition, situation needs to prepare its financial statements on the assumption that it will soon be subject to SOXA. Therefore, management must implement policies and procedures to enable them to prepare Section 404 reports.

Because of the uncertain timing of either exit event, many venture-backed private companies have concluded that they must be SOXA-compliant, even if an acquisition or an IPO is not imminent. Therefore, Section 404 compliance is a fact for companies that are clearly outside the intended reach of SOXA.

General comment

Our comments relate primarily to the impact of PCAOB rules on private companies that are not SOXA "issuers" and the need for PCAOB rules to allow auditors to exercise appropriate judgment in performing an audit of internal control over financial reporting. However, these comments are generally applicable to small publicly traded companies also.[3]

With regard to both types of companies, our main concern is that Section 404 be implemented in a cost effective manner. The Proposing Release states a similar view:

> "For a smaller, less complex company, the Board expects that the auditor will exercise reasonable professional judgment in determining the extent of the audit of internal control and perform only those tests that are necessary to ascertain the effectiveness of the company's internal controls."

PCAOB Release No. 2003-17 ("Proposing Release"), page 6. We believe that this statement sets up a test that should be applied to every aspect of PCAOB Rules**:** <u>does the standard provide sufficient flexibility for the auditor to exercise judgment in the extent of testing and, as to use of the work of others, including the work of management?</u>

Specific comment on Proposed Audit Standard, Appendix A to Proposing Release, ("Proposed Rules") pertaining to private and smaller publicly traded companies

One of the basic tenets of auditing is that auditors must exercise their professional judgment and expertise in determining the scope of the specific audit procedures to be performed. The Proposed Rules acknowledge that the auditor should apply the concept of materiality at both the financial-statement and the individual account-balance level. However, the Proposed Rules specifically limit the auditor's flexibility to exercise its professional

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[3] As we read the Act and PCAOB Rule 3100, we do not believe that audit firms, including PCAOB-registered audit firms, will be required *by law or regulation* to apply the proposed PCAOB rules to the audits of private companies.

judgment and expertise by requiring audit evidence to be obtained for "all" items in several situations. For example, the Proposed Rules state:

> "The auditor should perform a walkthrough for ***all*** of the company's significant processes." *Proposing Release,* page A-31, paragraph 79 [emphasis added].
>
> "The auditor should obtain evidence about the effectiveness of controls (either by performing tests of controls himself or herself (or by using the work of others) for ***all*** relevant assertions related to ***all*** significant accounts, relevant assertions, and significant processes…" *Id.,* page A-29, paragraph 74 [emphasis added].
>
> "The auditor should evaluate ***all*** controls specifically intended to address the risks of fraud that are reasonably likely to have a material effect on the company's financial statements, which may be a part of any of the five components of internal control over financial reporting, as discussed in paragraph 50." *Id*., page A-15, paragraph 24 [emphasis added].
>
> "Monitoring – The auditor's understanding of management's monitoring of controls extends to and includes it monitoring of ***all*** controls, including control activities, which management has identified and designed to prevent or detect material misstatement in the accounts and disclosures and related assertions of the financial statements." *Id.*, page A-23, paragraph 50 [emphasis added].
>
> "As part of this evaluation, the auditor should review ***all*** reports issued during the year by internal audit (or similar functions, such as loan review in a financial institution) that address controls relating to internal control over financial reporting and evaluate any internal control deficiencies identified in those reports." *Id.,* page A-40, paragraph 114 [emphasis added].

The Proposed Rules further limit the ability of auditors to exercise their professional judgment and expertise by limiting the extent to which auditors may use the work of others, including management and internal audit. Auditing standards historically have allowed the independent auditor to consider the work of internal audit when determining the nature and extent of their audit procedures. The Proposed Rules embrace this concept, but, also, limit the areas where reliance can be placed upon the work of internal audit. For example, work of internal auditors cannot be used for assessing: (1) the controls that are part of the control environment; (2) controls over the period-end financial reporting process; (3) controls that have a pervasive effect on the financial statements, such as information technology general controls; or (4) walkthroughs. This is overly restrictive, especially in the small company or private company context. If the auditor has determined in its professional opinion that the internal audit is sufficiently competent and objective, there should not be such limitations.

Under current auditing standards, auditors are able to use their assessment of the effectiveness of senior management controls and monthly boards of directors' oversight of company operations in their audits of smaller companies to limit the nature and extent of their work in a <u>financial statement</u> audit. Similarly, the Proposed Rules appear to acknowledge that the integrity and actions of senior management in small and medium-size organizations are key components of establishing strong internal controls in those companies. *Proposing Release, Appendix E.* For the same reasons, auditors of small and medium-size companies should be allowed, if warranted based upon their professional judgment and expertise, to use the work of management in their audit of internal controls over financial reporting, especially in performing walkthroughs.

We believe that by limiting the auditor's ability to exercise their professional judgment in each of the above situations, the Proposed Rules will impede the PCAOB's goal of implementing Section 404 in a cost effective manner. Indeed, many aspects of the Proposed Rules would have the opposite effect. They would require the auditor to unnecessarily increase the amount of work to be performed, which will result in higher costs with little added benefits to financial reporting.

We have an additional concern regarding the Proposed Rules – the requirement that the auditor evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting. *Proposing Release,* page A-25, paragraphs 56-59. Many of NVCA members serve on boards of directors and audit committees for their portfolio companies. These boards of directors and audit committees are responsible for the appointment and oversight of the external auditors. The Proposed Rule's requirement that auditors evaluate the effectiveness of the audit committee's oversight of internal control over financial reporting creates an unnecessary ambiguity in the relationship between the audit committee and the external auditor.

Comments on Proposed Rules related to venture-backed private companies, in particular

The "COSO Report" titled, *Internal Control – Integrated Framework*[4], provides the basis for the current proposed rules. *Proposing Release*, page 5. The COSO Framework explains that internal control in smaller companies can be less formal and structured. COSO, *Internal Control – Integrated Framework, Executive Summary, page 1.* This is an especially important consideration for developing auditing rules that will be applied to private, venture-backed companies.

In venture-backed companies, internal controls, systems and periodic testing of internal controls by management are commensurate to the risk that management and private investors, who sit on the board, find acceptable. There is no standard approach to these very subjective cost-benefit determinations.

In this private company context, the following statement has particular meaning. "The primary benefit [of internal controls over financial reporting] is to provide the company, its management, *its board and audit committee, and its owners* and other stakeholders with a reasonable basis to rely on the company's financial reporting." *Proposing Release*, page 5 [*emphasis supplied*]. In a venture-backed company, the current owners are members of the board and the audit committee. While we recognize that an auditor's 404 report will necessarily

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[4] Committee of Sponsoring Organizations of the Treadway Report, *Internal Controls -- Integrated Framework* (1992).

assume that the company will become a public company, or part of a public company, during the coming fiscal year, the PCAOB's 404 Rules must allow the auditor to accommodate the fact that costs and benefits are weighed differently for a private company than for even the smallest publicly traded company.

For example, the COSO framework notes that the control environment is "the foundation for all other components of internal control, providing discipline and structure," *Internal Control – Integrated Framework, Executive Summary, page. 2.* Accordingly, an auditor should be able to weight aspects of the control environment in determining how much they need to test other aspects of internal control in a private company.

In many small companies, a key control consists of the fact that financial management and authority is centralized at the CEO or CFO level. If this is the case in a given company, the auditor should be permitted to assign significant weight to those facts alone in determining whether to test other functions. If, in addition, the board meets monthly to review the company's finances in detail – a common practice in portfolio companies -- the auditor should have the latitude to find it unnecessary to do additional extensive testing to determine whether the owners (board members) have "a reasonable basis to rely on the company's financial reporting," *Proposing Release*, page 5. Internal control costs, and the cost of evaluating internal controls should be weighed against their benefits to financial reporting. If there is no real benefit, a particular review or test should not be required.

The COSO Framework's emphasis on control environment has particular application in the private company context. The board of directors' cost-benefit choices should, by themselves, carry significant weight absent some indication of special financial reporting risks. Just as the Proposed Rules should provide auditors with the flexibility to make appropriate cost-benefit judgments for smaller public companies, they must be still more flexible for the appropriate balance to be struck in a private company 404 report.

Conclusion

NVCA encourages the PCAOB to expand the scope of special internal control considerations for small and medium-sized companies in the Proposed Rules. We also request that the Rule note that different considerations apply in preparing a report for a private company. Without such special considerations, the audits of internal control over financial reporting for these companies will be unnecessarily costly, both in external auditor fees and management and board time that will be devoted towards Section 404 compliance. We would be pleased to discuss these and any related matters with Board members or staff. Please feel free to contact NVCA's Vice President Jennifer Connell Dowling, our outside SEC counsel, Brian Borders (202 822 9306), or me to discuss these matters.

Sincerely yours,

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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

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[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

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[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 <u>Bring-Down Procedures for Audit Report and Consent Filings</u>

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 <u>Weaknesses in All Cases</u>

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.

* * *

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,

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

New York State Bar Association
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Business Law Section
Committee on Securities Regulation

November 25, 2003

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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.

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[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. 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)

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. <u>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)</u>

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 <u>*/s/*Michael J. Holliday</u>
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CHAIR OF THE COMMITTEE

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The Honorable Daniel L. Goelzer, Member
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The Honorable Charles D. Niemeier, Member

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November 21, 2003

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By e-mail: comments@pcaobus.org

Re: 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
PCAOB Rulemaking Docket Matter No. 008

The New York State Society of Certified Public Accountants, the oldest state accounting association, representing approximately 30,000 CPAs, welcomes the opportunity to comment on the Proposed Auditing Standard referenced above.

The NYSSCPA Auditing Standards and Procedures Committee deliberated the Exposure Draft and, with assistance from the Technology Assurance Committee, prepared the attached comments. If you would like additional discussion with the committee, please contact Margaret Wood, chair of the Auditing Standards and Procedures Committee, at (212) 542-9528, or Robert Colson, NYSSCPA staff, at (212) 719-8350.

Sincerely,

Jeffrey R. Hoops
President

Attachment

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530 fifth avenue, new york, ny 10036-5101
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COMMENTS ON PCAOB 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

PCAOB Rulemaking Docket Matter No. 008

November 21, 2003

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General Comments

The proposed rules appropriately integrate the audits of internal control over financial reporting with the audits of financial statements. The proposed rules are clearly written. They provide understandable guidance on the conduct of an audit of internal control over financial reporting. See the specific comments that follow for responses to the Board's request for feedback on 31 specific questions.

Specific Comments

Question 1.

It is appropriate to characterize the auditor's attestation of management's assessment of the effectives of internal control as an audit of internal controls over financial reporting. Currently, professional standards distinguish between auditing standards and other attestation standards for agreed-upon procedures and other non-financial statement engagements. Attestation standards generally indicate a level of assurance less than an audit. Labeling the engagement covered in these proposed rules something other an "audit" would lead to additional problems with the expectations gap. The intent of the proposed rules implies a level of assurance consistent with an audit.

Question 2.

The two functions identified in this question are integral. Although they can be separate, the requirement that the auditor opine on the financial statements virtually requires that the same auditor has performed the audit of the internal controls over financial reporting because the integrity of the internal controls leads to the integrity of the financial reports.

Question 3.

The audit of internal controls over financial reporting is not sufficient to ensure that the financial statements are free from material misstatements that would only be detected by the completion of an audit of the financial statements. Paragraph 15 of the proposed rules identifies circumstances where a circumvention of internal controls would only be discovered by a complete financial statement audit.

Question 4.

Appendix E provides an excellent discussion of the nature of internal controls over financial reporting in small and medium-size companies. Nonetheless, the contents of Appendix E are not adequately addressed in the situations covered in Appendix B or in the section on Performing an Audit of Internal Control over Financial Reporting.

Question 5.

It would be inappropriate to specify competence or experience levels within a specific standard because such a practice would promote a “check list” mentality whereby procedures could be narrowly defined to allow the letter of the law to be followed but the spirit violated. Rather, competence and experience should be covered in a general standard, and auditors should be assigned according to the knowledge and skills needed for a specific engagement. In fulfillment of any such general standard, it would not be appropriate for an inexperienced auditor to have primary responsibility for activities such as the one identified in the question.

Question 6.

The auditor must evaluate management’s assessment and directly obtain evidence about the effectiveness of internal over financial reporting in order to satisfy audit and legal requirements. The latter is required because the auditor must have such direct evidence in order to express the opinion required by the proposed rules. The former is required because the statute and SEC regulations on which the proposed rules are based require assurance concerning management’s assessment process. Nonetheless, the auditor must take care to not simply re-perform the same tests of internal control that are in management’s assessment.

Question 7.

Yes, it is appropriate that the PCAOB provide such criteria.

Question 8.

Paragraphs 46 and 47 of the proposed rules appropriately deal with this question. Paragraph 46 indicates that there could be varying degrees of inadequate documentation. The determination of whether an inadequacy of documentation should rise to the level of a significant deficiency or a material weakness should be left to the judgment of the auditor based on the definitions in paragraphs 7 – 9.

Question 9.

It is clear that the proposed rules require a walkthrough. The proposed rules should be clarified to ensure that the walkthrough commences at the boundary event that starts the transaction and follows its processing through the system to the financial statements. Such a complete walkthrough will require different skills for different tasks, and special attention will be necessary to ensure that a walkthrough is performed through the IT system as well as through controls around the IT system.

Question 10.

Walkthroughs should be performed by members of the audit team, with specialists performing those aspects of walkthroughs that demand special knowledge, with particular attention to IT knowledge and skills.

Question 11.

While the auditor should be encouraged to use all knowledge gained from previous experience with the client's internal control over financial reporting in the planning and implementation of the current year's audit, it remains necessary to perform test in each period to obtain sufficient, competent evidence that the system is functioning properly.

Question 12 and Question 13.

The criteria listed in paragraphs 103 – 106 of the proposed rules are appropriate for guiding the auditor's use of the work of management and others.

Question 14.

Paragraph 108 – 110, along with the examples in Appendix B (B20 and B23), gives the appropriate recognition to the degree of reliance on the work of internal auditors.

Question 15.

The auditor should be given flexibility in determining the extent that re-performance of management's tests of internal control over financial reporting is necessary. Paragraph 109 appropriately requires the auditor perform enough testing himself or herself so the auditor's own work provides the principal evidence.

Question 16.

Yes, although some may want more guidance on what constitutes "principal evidence."

Question 17.

The definitions in paragraphs 8 and 9 use terms familiar to accountants from SFAS 5, *Accounting for Contingencies*. The definitions improve the standards as compared to what is in current use. In the final analysis, there will always be subjective judgments, but the proposed definitions will increase the consistency in the evaluation of deficiencies.

Question 18.

The examples in Appendix D are helpful. Other examples include:

- Lack of documentation of one of the five components of internal control.
- Access rights that allow personnel to change accounting records without detection.
- Weak password controls.
- Weak or non-existent security controls over critical IT assets that are pervasive to internal control.

Question 19.

Yes, otherwise the auditor would not have an adequate basis for determining whether a deficiency was a significant deficiency or a material weakness.

Question 20.

The auditors should communicate all identified internal control deficiencies to management in writing.

Question 21.

Paragraphs 126 and 127, and the examples in Appendix D, appropriately classify strong indicators that a material weakness in internal control exists. It would be helpful for the Board to update paragraph 126 and Appendix D on a periodic basis.

Question 22.

There is an inherent conflict of interest when the auditors evaluate the effectiveness of the audit committee that hires them.

Question 23.

The auditor is not in a position to effectively evaluate the effectiveness of the audit committee's oversight. This is a responsibility that rests with the company's board of directors, the SEC, or some other body that is not in the employ of the audit committee.

Question 24.

Withdrawal from an audit of internal control over financial reporting should result only after the auditor determines that management, the audit committee, and the board does not respond appropriately to identified material weaknesses.

Question 25.

Yes. The alternative would be confusing if not misleading.

Question 26.

No. “Except for” opinions would result in further confusion.

Question 27.

The auditor should speak directly to the effectiveness of internal control over financial reporting in the opinion.

Question 28.

Independence is a foundational concept for auditors. Guidance on independence should come in a separate document.

Question 29.

This question addresses independence issues, and it should be addressed separately in an independence standard.

Question 30.

It is appropriate to require a different level of work at the quarter than at year end; however, the proposed rules appropriately require the auditor to obtain an understanding of, and to test by inquiry and observation, changes in the internal control over financial reporting on quarterly basis.

Question 31.

Yes, the scope of the auditor’s quarterly responsibilities is clearly stated and appropriate.

November 26, 2003

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

Subject: PCAOB Rulemaking Docket Matter No. 008

PCAOB:

I appreciate the opportunity to comment to the Public Company Accounting Oversight Board (the "Board" or "PCAOB") on the Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* (the "Proposed Standard"). My responses to the questions put forth in the Proposed Standard are attached as an exhibit to this letter. My response is solely my own and does not necessarily reflect the views of Northrop Grumman Corporation, my employer.

I commend the Board in its efforts to provide guidance to help management of publicly traded companies and auditors comply with Section 404 of the Sarbanes-Oxley Act (the "Act"). While I agree with the principal objectives of the Act in restoring investor confidence in the American financial system, I have significant concern that the guidance as proposed will result in far too much redundant, valueless effort by the auditors caused by the over-application of mandated procedures. As a consequence the cost required to comply with Section 404 of the Act will be much greater than either Congress or the SEC envisioned with no basis, other than shear hope that somehow this will aid in the much-sought for restoration of investor confidence. I believe that the revisions needed to remedy the guidance so it will not have the consequences that I believe were not intended when the Act was passed are not extensive.

My principal concern is the massive amount of hours that the proposed guidance will require to comply with Section 404 of the Act. The effort and cost simply will be too much. I know of one instance in which a registrant has been provided an estimate by a Big Four accounting firm of between 60,000 and 80,000 hours, just for the testing phase related to control activities (i.e. not including the effort needed for organization, strategy and design efforts to date, hours required for addressing the other components of COSO, software costs, etc.). In addition, the independent auditors have provided tht registrant a 2004 audit estimate of approximately 30,000 hours. The resources needed to supply this many hours of effort will likely approach $15 million!

I believe in the importance of restoring investor confidence and I believe most registrants are willing to make reasonable efforts, but I do not believe the effort required to accomplish that goal requires anywhere near that effort or cost.

I believe that the Proposed Standard should set forth a scope of work designed to assess and test the tone at the top, i.e. the control environment. That belief is based on the overwhelming indicators that the scandals that resulted in the loss of investor confidence stemmed from control environments that were not conducive to effective internal control over financial reporting. I am unaware of any indications that breakdowns in internal controls related to control activities had anything to do with the scandals. In other words it wasn't poor control over such activities as payroll processing, bill collection, or accounts payable recording that were at fault. Rather, it was malfeasance and irregularities and, quite likely fraud, perpetrated at the highest levels that caused all the trouble. That is where the focus needs to be in the guidance. We believe the effort that would be required to assess and test the control environment would be far less than the effort required by the proposed guidance with no discernible lessening of the likelihood that compliance with 404 will have on the goal of restoring investor confidence. *Management's Assessment* – Management would assess control environment, risk assessment, information and communication and monitoring each year. For control activities, management would document and assess the design effectiveness of all key controls associated with all processes of material (quantitatively and qualitatively) accounts and disclosures each year. The process associated with each account and disclosure would then be categorized as significant or non-significant based more on the qualitative factors such as importance to the business and an assessment of risk. For example at NGC the following accounts and processes would be considered significant and therefore addressed each year; any account or process related to contracts (revenue,

cost, accounts receivable, loss provision, pricing, estimation), compensation, cash, goodwill, pension, taxes, general computer controls. Each control associated with a significant account, as well as those controls associated with non-significant accounts where a significant change had occurred, would be tested each year for operational effectiveness using a higher scope than controls related to non-significant accounts and disclosures. Controls associated with all other accounts and processes could be considered non-significant and would be tested each year for operational effectiveness using a much lower scope and, perhaps, relying to some degree on the results of prior year testing. Any non-significant area where deficiencies are identified would be tested using an increased scope in the current and subsequent year.

Auditor Scope - Assuming the work of management or others is performed by competent and objective individuals, the auditor should be allowed to place reliance on that work with the result that very little work should be required to be performed in areas other than the control environment. For those controls associated with processes, accounts or disclosures deemed significant, the auditor would perform tests sufficient to verify management's assessment each year. For those controls associated with processes, accounts or disclosures deemed non-significant, the auditor, depending on facts and circumstances, should be allowed the discretion to rely entirely on the work performed by management or, at most, verify the work of management or others by making random selections of that population.

Once again, I wish to express my appreciation to the Board for the opportunity to respond to the attached questions and respectfully ask the Board to consider my concerns and suggestions. I would be pleased to discuss these matters with the Board at any time.

Yours truly,

Steven J. Root
Director Finance Administration and Process
Northrop Grumman Corporation

EXHIBIT

PCAOB PROPOSED AUDITING STANDARD

Response to Questions Prepared By

Northrop Grumman Corporation

<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?*

   Response: I believe it is acceptable 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. However, I fail to understand why such a reference is desirable. In other words, I see no disadvantage to using the attestation reference regarding management's assessment of internal control. In fact, if the guidance were to be revised in accordance with my suggestions it might be more accurate to retain the attestation reference.

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?*

   Response: While I am concerned with a separate audit of internal control over financial reporting without the corroborative evidence obtained from performing the audit of the associated financial statements, I believe the auditor should not be prohibited from performing an audit of internal control over financial reporting without also performing an audit of the financial statements. I do believe the auditor should be prohibited from performing an audit of the financial statements without also performing an audit of the internal control over financial reporting.

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?*

   Response: I am unable to envision the frequency of instances where this requirement would come into play. Every SEC registrant must file annual audited financial statements and SO 404 applies to all registrants so it appears to me that reports on internal controls and reports on financial statements are entwined. While I do not believe the auditor who performs an audit of the internal control over financial reporting should be required to perform an audit of the associated financial statements, in such cases the Board may consider mandating additional audit procedures of key financial accounts in order to obtain additional corroborative evidence of operational effectiveness.

<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?*

   Response: I have no comment regarding this issue.

<u>Question regarding the audit of internal control over financial reporting:</u>

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.*

   Response: I believe the AICPA Professional Standards adequately address the auditor's duties and responsibilities concerning the training, proficiency and supervision of the independent auditor. However, for reasons already set forth, I believe that the scope of work mandated by the proposed guidance will cause auditors to perform considerable work in areas related to processes for which they have scant knowledge, proficiency or experience. Much of the work, by necessity, will have to be performed by juniors and seniors. Even with supervision, it is difficult to see how this arrangement will result in quality assessments given the magnitude of processes and the bodies of knowledge requisite to operate them effectively. To illustrate, at one registrant of which the writer is aware, itwill be assessing more than 1200 processes in roughly 50 categories. The persons that "own" these processes each have several years of experience and considerable acumen with regard to the particular circumstances of their respective "worlds". These people are honest, professional, and competent. They are part of the management of the registrant. This proposed guidance will subject them to scrutiny by persons considerably less experienced and knowledgeable. It is difficult to see how this can be construed to be an exercise that will result in valuable insights, or even sound judgments by the auditors. But it is unmistakable that it will cost a great deal.

<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?*

   Response: I agree with the premise stated in the Proposed Standard that the more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be. I strongly believe that the auditor should be given greater flexibility than stated in the Proposed Standard to use the work of management or others who are competent and objective as evidence about whether internal control over financial reporting is effective. I am concerned, as indicated earlier, that the standard, as proposed, will result in a very significant and unnecessary, duplication of effort on the part of the auditor of work performed by management.

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

   Response: I believe the criteria to evaluate the adequacy of documentation as proposed to be appropriate.

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 a significant deficiency or material weakness in internal control?*

   Response: While I believe that inadequate documentation is not necessarily, of itself, a control deficiency, I agree that adequate documentation supports the evaluation of the effectiveness of the overall internal control system. A determination of the adequacy of documentation is a matter of judgment. The auditor's determination of whether inadequate documentation rises to the level of a significant deficiency or material weakness should be based on the attendant facts and circumstances; the significance as it relates to effectiveness, how pervasive the documentation inadequacies, the relevance to other COSO components, etc.

<u>Questions regarding obtaining an understanding of internal control over financial reporting:</u>

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

Response: WhileI believe walkthroughs are an important auditing tool, I do not believe they should be required. Once again, I believe the auditor should be allowed to use his or her professional judgment to determine what areas of a particular process to audit, the appropriate auditing procedure and the degree of reliance upon the work of management or others.

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?*

    Response: I strongly believe the auditor should be allowed to use the walkthrough procedures performed by management, internal auditors, or others. As a determination of audit scope, I believe that the auditor should consider whether or not management has used walkthroughs as a part of their assessment process. The auditor should be permitted by the guidance to judgmentally select certain key processing procedures or controls associated with certain significant processes to verify the assessment made by management, internal auditors, or others.

<u>Questions regarding testing operating effectiveness:</u>

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?*

    Response: I strongly disagree with the premise that the auditor must obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year. The auditor should be allowed to consider the audit evidence obtained in previous years in deciding upon the scope of work needed in the current year to support his or her current opinion on management's assessment. I believe the Board should define the audit criteria to assess whether any significant changes to a particular process have occurred since the prior year. If the criteria indicate no significant changes, I believe the Board should define an appropriate minimum scope of procedures for the auditor to apply to verify the continued effectiveness based, in part on considering the work performed and the results of the previous year.

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?*

    Response: I agree with the premise stated in the Proposed Standard that the more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be. I believe the auditor should be permitted to use the results of testing for any control activity where those individuals performing the work are deemed by the auditor to be both competent and objective. For control activities, management would document and assess the design effectiveness of all key controls associated with all processes of material (quantitatively and qualitatively) accounts and disclosures each year. The process associated with each account and disclosure would then be categorized as significant or non-significant based more on the qualitative factors such as importance to the business and an assessment of risk. For those controls associated with processes, accounts or disclosures deemed significant, the auditor would reperform a sampling of tests initially performed by management sufficient to verify management's assessment. For those controls associated with processes, accounts or disclosures deemed non-significant, the auditor should be allowed, under the best circumstances, to rely entirely on the work of management or others.

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

    Response: See my responses to questions 5, 9, 10 and 12 above.

14. *Does the proposed standard give appropriate recognition to the work of internal auditors? If not, does the proposed standard place to much emphasis and preference on the work of internal auditors or not enough?*

    Response: I believe the recognition to the work of internal auditors Should be expanded to enable reliance to be placed their work, even in areas such as the control environment and areas of significant disclosures.

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 tends to use)?*

    Response: While I believe it appropriate for the auditor to have flexibility in determining the extent of reperformance procedures, more guidance is needed in this area. Assuming the work of management or others is performed by individuals who are determined to be competent and objective, we believe 1) for significant processes, accounts and disclosures, some level of reperformance should be required but that the work of others be taken into consideration by the auditor to reduce the work that otherwise would be called for, and 2) for non-significant processes, accounts and disclosures, the auditor should be allowed considerably more discretion and lower the scope of reperformance compared to significant processes, accounts and disclosures. See my response to question 5, 12, and 14.

16. *Is the requirement for the auditor to obtain the principal 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?*

    Response: I strongly disagree with the requirement for the auditor to obtain the principal evidence, on an overall basis, through his or her own work, as an appropriate benchmark for the amount of work required to be performed. I believe such a benchmark is unnecessary to achieve the audit objectives. I believe the additional hours required by such a benchmark above that necessary to form an opinion of management's assessment is detrimental to the entire process by focusing the auditor's attention on a quantitative measure of performance versus a qualitative, risk based approach. While a quantitative measure of audit scope may be appropriate in forming the opinion on the financial statements, I believe the principle of flexibility and the use of judgment, as discussed in question 15 above, to be the appropriate standards when forming an opinion on subjective matters such as the effectiveness of internal controls.

Questions regarding evaluating results:

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?*

    Response: The definitions in the Proposed Standard of significant deficiency and material weakness appear appropriate.

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?*

Response: Although the examples in Appendix D provide helpful guidance, I am concerned that such guidance will be misinterpreted or stringently applied without the use of judgment on the part of the auditor. The auditor should be reminded that professional judgment should be applied, and is the overriding factor, in all cases based on the specific facts and circumstances.

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

Response: I believe it is necessary to evaluate the severity of all identified control deficiencies. As stated in the response to question 18 above, the auditor should use professional judgment in all cases when evaluating control deficiencies based on the specific facts and circumstances.

20. *Is it appropriate to require the auditor to communicate all internal control deficiencies (not just material weaknesses and significant deficiencies) to management in writing?*

21. ***Response:*** There is much practical difficulty with this proposed requirement. I believe that only significant deficiencies or material weaknesses should be communicated to management in writing. All other deficiencies, individually or in the aggregate, would be those that result in a remote likelihood that a misstatement of the annual or interim financial statements that is inconsequential in amount will not be prevented or detected. Based on such a definition, and as the determination of any deficiency is the result of judgmentI believe that a written communication of such deficiencies is not warranted and, in fact, may cause misleading inferences to be drawn, particularly in situations in which the writing becomes the subject of discovery in a subsequent legal proceeding against the company. *Are the matters that the Board has classified as strong indicators that a material weakness in internal control exists appropriately classified as such?*

Response: See my response to question 18.

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?*

Response: As the audit committee is also responsible for hiring the auditor, I believe the proposed requirement of the auditor to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting creates a conflict of interest. Such a conflict of interest is adverse to the relationship that must prevail between the auditor and the audit committee if the control environment is to be effective. As a practical matter, management must make an assessment, under COSO, of the effectiveness of the audit committee as part of the control environment. The auditor must then audit management's assessment. I believe the Board should address further this conflict and resolve it by eliminating the requirement.

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

    Response: See my response to question 22 above. It is unrealistic to expect that this proposed duty can be carried out effectively.

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?*

    Response: I have no comment regarding this issue because I oppose the proposed requirement in the first place.

Questions regarding forming an opinion and reporting:

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?*

    Response: I believe an adverse conclusion about the effectiveness of the company's internal control over financial reporting should be based on the professional judgment of the auditor due to the existence of a material weakness or weaknesses that are of such significance and pervasiveness as to create a reasonable doubt about the company's ability to produce accurate and timely financial statements. I believe the fact that a material weakness exists is insufficient by itself to create the level of doubt that would necessitate an adverse opinion.

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

    Response: I believe any conclusion about the effectiveness of the company's internal control over financial reporting should be based on the professional judgment of the auditor and only when an adverse opinion is issued (see my response to question 25 above). Where the facts and circumstances surrounding a material weakness or weaknesses are such that the auditor believes, on the whole, the company's system of internal controls are conducive to accurate and timely financial reporting, then the auditor should have the option to express a qualified "except for" conclusion on management's assessment and not on the effectiveness of internal control. The Board should consider additional guidance on this matter.

27. *Do you agree with the position that when the auditor issues a nonstandard 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?*

    Response: I believe that the auditor's opinion should speak directly to the effectiveness of the internal control over financial reporting only when an adverse opinion is issued. Only in this circumstance is the auditor drawing a conclusion as to effectiveness versus the assessment of management. In all other conclusions the report should speak to whether management's assessment is fairly stated.

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?*

    Response: I believe existing independence rules are sufficient subject to my response to question 29 below.

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

    Response: I believe the auditor should be prohibited in performing any internal control-related non-audit services.

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 (forth quarter) certification, appropriate?*

    Response: I believe the auditor's differing levels of responsibility as they relate to management's quarterly certifications versus the annual (forth quarter) certification are appropriate.

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

    Response: I believe the scope of the auditor's responsibility for the quarterly disclosures about the internal control over financial reporting to be appropriate.

*   *   *   *   *

Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of Thrift Supervision

December 1, 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

Dear Board Members:

We appreciate the significant efforts of the Public Company Accounting Oversight Board (PCAOB) to propose and implement enhanced standards for the auditing of and reporting on the internal controls over financial reporting of public companies. In addition, we found the roundtable discussion on July 29, 2003, to be a useful and important aspect of the due process in the development of this proposal and we appreciated the opportunity to have participated in that discussion. Effective auditing, strong internal controls, and reliable financial reporting are critical to the safety and soundness of the organizations we regulate and, thus, we recognize the importance of an open and productive dialogue on these matters of mutual interest.

Since 1993, the Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision (collectively, the Agencies) have been responsible for evaluating insured depository institutions' implementation of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA 112). As you know, FDICIA 112 requires management of insured depository institutions with total assets of $500 million or more to annually assess and report on whether their internal controls over financial reporting are effective, and requires an independent accountant's attestation report on management's assertion. Thus, our collective experience examining depository institutions' internal control assessments and independent accountants' attestation reports provides unique insight into the practice of auditing and reporting on internal controls over financial reporting.

Overall, the PCAOB's proposed auditing standard, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements," is a significant improvement over the existing attestation standard, "Reporting on an Entity's Internal Control Over Financial Reporting." The proposed standard presents improvements in the areas of (1) identifying management's responsibilities in an internal control audit, (2) explaining the relationship between audits of internal controls and of financial statements, (3) describing the effect of internal control deficiencies on the auditor's conclusion, and (4) specifying appropriate reporting approaches.

Based upon our review of the proposed standard, we are providing you with specific answers to certain questions in the release, as well as additional comments that we recommend to further improve the standard. The attachments to this letter provide our detailed comments. Please feel free to contact us if you wish to discuss our comments further.

Sincerely,

Zane D. Blackburn
Chief Accountant
Office of the Comptroller of the Currency

Gerald A. Edwards, Jr.
Associate Director and
Chief Accountant – Supervision
Federal Reserve Board

Robert F. Storch
Chief Accountant
Federal Deposit Insurance Corporation

Timothy J. Stier
Chief Accountant
Office of Thrift Supervision

Attachment 1 – Response to Specific Request for Comments - PCAOB Rulemaking Docket No. 008
Attachment 2 – Comments on Proposed Auditing Standard – PCAOB Rulemaking Docket No. 008

cc Donald T. Nicolaisen, Chief Accountant, Securities and Exchange Commission
Scott A. Taub, Deputy Chief Accountant, Securities and Exchange Commission
Eric J. Schuppenhauer, Professional Accounting Fellow, Securities and Exchange Commission

Attachment 1
Response to Specific Request for Comments
PCAOB Rulemaking Docket No. 008

General Responses

The federal banking agencies support the position outlined in the PCAOB's proposal with regard to the issues raised in questions 1 – 7, 9 – 10, 13 – 15, 17 – 18, 21 – 22, and 30 – 31. We have, therefore, not provided specific responses to these questions. However, we are providing responses to questions 8, 11 – 12, 16, 19 – 20, and 23 – 29, because we believe the PCAOB will find it useful to consider the agencies' experience with similar matters in the attestation process for internal controls at insured depository institutions.

Specific Responses

Questions regarding evaluation of management's assessment:

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?

Response: In our experience, management's inability to adequately document its internal controls or its assessment of internal controls can be an indicator of a significant control deficiency within an organization. Thus, the standard should require the auditor to evaluate whether documentation deficiencies rise to the level of a significant deficiency or a material weakness as indicated in paragraphs 46, 47, and 125.

Question regarding testing operating effectiveness:

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?

Response: Paragraphs 94 – 100 indicate the timing of the auditor's tests should be adequate to determine whether the controls are effective as of the date specified in management's report. The clear implication of these paragraphs is to require the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year. Prior evidence would not be sufficient, particularly when business practices and internal controls have changed.

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?

Attachment 1
Response to Specific Request for Comments
PCAOB Rulemaking Docket No. 008

Response: Paragraphs 104 – 105 provide guidance on instances where the auditor is either prohibited or limited from relying on the results of procedures performed by others when rendering an opinion on internal controls. In our experience, auditors have a tendency to rely too heavily on the work of management and others when performing internal control attestations. The inherent risk of such over-reliance diminishes the independence and objectivity of the auditor's opinion on control effectiveness. The requirement that the auditor obtain the principal evidence for the audit opinion would seem to preclude the auditor from relying on the work of management and others for most of the relevant assertions on significant accounts and disclosures. Thus, we recommend that the PCAOB clarify the meaning of the term "use the work of management or others" in the context of paragraphs 104-106. In addition, the standard should better explain the extent to which the results of tests performed by others, such as internal auditors, may or may not be relied upon by the auditor.

16. Is the requirement for the auditor to obtain the principal 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?

Response: Our expectation is that the principal evidence standard would preclude the auditor from relying primarily on the work of management and others. Thus, the proposed approach appears to be an appropriate benchmark.

Questions regarding evaluating results:

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

Response: Yes. It appears that an auditor would need to evaluate the severity of all deficiencies to appropriately determine whether the deficiencies collectively or individually rise to the level of a significant deficiency or material weakness. In our experience, auditors routinely make such judgments in the normal course of an audit. As a result, the requirement to assess the severity of deficiencies should not significantly increase the amount of work performed by an auditor.

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?

Response: Yes. Paragraphs 190 – 192 require auditors to communicate all control deficiencies and fraud to management and the audit committee. This type of communication is consistent with the objective of Section 404 of the Sarbanes-Oxley Act of 2002, which is intended to ensure that the organization maintains an effective system of internal control. Since auditors routinely become aware of deficiencies of lesser magnitude than a material weakness in the course of an audit, there should be little added burden associated with communicating these deficiencies in writing. In addition, written communication provides a

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clear audit trail for the audit committee, management, auditors and regulators. In our experience, written communication of all identified deficiencies to management and the audit committee facilitates prompt resolution of the deficiencies.

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

    Response: Yes. Despite the inherent difficulties in evaluating the body directly responsible for appointing and compensating the auditor, it is quite appropriate for the auditor to evaluate the effectiveness of the audit committee. Paragraphs 57 – 58 enumerate factors that the auditor should evaluate related to the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting. We believe that auditors have the professional qualifications, experience and knowledge to effectively carry out this responsibility.

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?

    Response: No. Paragraph 59 appropriately indicates that an auditor's determination that an audit committee is ineffective should, at least, be regarded as a significant deficiency. If the auditor concludes that the deficiencies in audit committee oversight rise to the level of a material weakness, the auditor should be required to issue an adverse opinion on the effectiveness of controls. It would seem to be inconsistent with the objective of the standard to suggest that an auditor should withdraw from an engagement rather than issue an adverse opinion on internal control effectiveness.

Questions regarding forming an opinion and reporting:

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?

    Response: Yes. It is appropriate for the existence of a material weakness to result in an adverse audit opinion. Paragraphs 162 – 164 and Appendix A provide appropriate guidance on adverse opinions resulting from the existence of material weaknesses. Based on this guidance, users of internal control reports would reasonably expect the existence of a material weakness to result in an adverse conclusion by both management and the auditor. The only logical outcome of the existence of a material weakness would be that internal control is not effective.

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

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Response: No. Paragraphs 15 – 18 explain the inherent limitations of internal control and the level of assurance users expect from reports on internal control. The use of "except for" opinions to explain the impact of deficiencies of a lesser magnitude than a material weakness would not send a clear message to users of internal control reports. Users expect the auditor's report to render an opinion on internal control taken as a whole. Qualified (i.e., "Except for") opinions diminish the usefulness of these reports.

27. Do you agree with the position that when the auditor issues a nonstandard 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?

Response: Yes. Consistent with our responses to questions 25 and 26, users expect audit opinions on internal control to be meaningful. As such, it would be more beneficial to users for the opinion to speak directly to the effectiveness of internal control rather than opine on management's assertion.

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?

Response: No. The Securities and Exchange Commission (SEC) adequately addressed auditor independence in its final rule release *Strengthening the Commission's Requirements Regarding Auditor Independence*. The PCAOB should work with the SEC to develop questions and answers and other implementation guidance on auditor independence.

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

Response: Consistent with our response to question 28, we recommend the PCAOB work with the SEC to develop consistent guidance on any prohibition of specific internal control-related non-auditor services.

Attachment 2
Comments on Proposed Auditing Standard
PCAOB Rulemaking Docket No. 008
An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

Requirements for Written Representations

Paragraph 128(g) directs the auditor to obtain written representation from management stating whether, subsequent to the date being reported on, there were "any changes in internal control or other factors that might significantly affect internal control." Since the determination of what constitutes a significant change in internal control is subjective, we recommend requiring the auditor to review the documentation management used to make its written representation regarding changes in internal control. This would enable the auditor to make an independent determination as to whether management had a reasonable basis to support its written representation regarding the significance of any changes in internal control.

Appendix A

2. The illustrative reports on the effectiveness of internal control over financial reporting expressing a qualified opinion and disclaiming an opinion, Examples A-3 and A-4 respectively, do not indicate the effect of such opinions on the financial statement audit. We recommend that language similar to that in the last sentence of the "Explanatory Paragraph" of Example A-2, which is an adverse opinion, be included in the illustrative reports for Examples A-3 and A-4.

Appendix B

3. Paragraphs B3, B12, and B13, and Illustration B-1 indicate that it is not necessary to test any controls at locations and business units that "...individually, and when aggregated with others, could not result in a material misstatement to the financial statements." Since controls exist for designated purposes, we do not consider it appropriate or constructive to simply exclude groups of locations and units from potential testing. For the hypothetical company depicted in Illustration B-1, 40% (60 of 150) of the company's locations would never be tested. In our opinion, this process could result in a scope limitation on management's assertion because it, by design, restricts the locations or business units that are actually evaluated by management. While individual locations or business units may not be significant and may not result in a material misstatement to the financial statements as of a point in time, the nature of the activities and transactions at ostensibly "insignificant" locations or business units, together with a lack of managerial oversight and internal control testing, could be conducive to and result in material internal control weaknesses, improper transactions, or fraud. Removing any location or business unit from the population of locations or business units to be considered in the review of internal control or audit of the financial statements could create a wrong impression or create a climate whereby management or other employees may take advantage of the lack of review of internal controls at these so-called "insignificant" locations or business units. We suggest the aforementioned paragraphs and illustration

Attachment 2
Comments on Proposed Auditing Standard
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An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

be revised to require management and the auditor to include testing of at least a sample of the controls over financial reporting at "insignificant" locations or business units to allow management and the auditor to assert that all controls are operating effectively. We believe no business unit or location should be permanently excluded from testing. We recommend paragraphs B3, B12, and B13, and Illustration B-1 be revised to read as follows:

> "Management and auditors should periodically test controls at a sample of locations and business units regardless of whether they are individually significant or, when aggregated, may result in a material misstatement to the financial statements."

Ohio Retirement Systems

November 24, 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

Dear Mr. Secretary:

The Ohio Retirement Systems (ORS) collectively manage $115 billion in assets and serve 1.5 million Ohioans. We strongly support the Public Company Accounting Oversight Board's (PCAOB) proposed auditing standard, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements."

The passage of the Sarbanes Oxley Act of 2002 was a watershed event in corporate governance. However, the PCAOB proposed rule is the next step forward that will strengthen internal controls to further provide protection to investors from accounting fraud at publicly traded companies. Unfortunately, as a result of Enron, Worldcom, Health South and other companies where large scale accounting fraud has been discovered, investors are all too familiar with the massive losses that result from a lack of effective internal controls and the absence of an effective audit committee.

With respect to certain specific provisions in the PCAOB proposed rule, our comments are as follows:

- We strongly believe that the auditor should be required to gather evidence through testing prior to evaluating whether management's internal control processes are effective and that management's assertion is fairly stated. In the absence of a testing requirement, the auditor's role would be minimized to merely rubber stamping management's attestation without any independent basis upon which to make the determination that the attestation accurately represents the effectiveness of the company's internal controls.

- Testing by the auditor is particularly important for controls intended to prevent or detect possible fraud. For this purpose, the auditor should not be permitted to rely on the work of others.

- It is also imperative that the auditor be required to evaluate the severity of internal control deficiencies that are discovered through testing by the auditor or that are identified by management. Examples of strong indicators of a material weakness are ineffective oversight, a material misstatement in the financial statements that is not initially identified by the company's internal controls, and significant deficiencies that have been communicated to management and the audit committee, but remain uncorrected.

- It is particularly important that the auditor be required to evaluate the effectiveness of the audit committee itself. Stronger, more effective audit committees are imperative for preventing financial fraud and protecting investors.

We strongly support the PCAOB proposed rule. Although this proposed rule may result in some increase in audit costs, the benefits will greatly outweigh the potential cost increase. Furthermore, the PCAOB proposed rule will help restore investor confidence in the integrity of the financial statements of publicly traded companies. We urge you to proceed in a timely manner to make the proposed rule a final rule, which will strengthen internal controls for the protection of investors.

Should you need any additional information, please feel free to contact Cynthia L. Richson, Corporate Governance Officer at the Ohio Public Employees Retirement System at 614/222-0398 or by e-mail at crichson@opers.org.

Sincerely,

J.P. Allen, Chair
Highway Patrol Retirement System

Robert M. Beck, Chair
Ohio Police and Fire Pension Fund

Charlie Adkins, Chair
Public Employees Retirement System of Ohio

Eugene E. Norris, Chair
State Teachers Retirement System of Ohio

Barbara J. Miller, Chair
School Employees Retirement System of Ohio

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November 18, 2003

Office of the Secretary
PCAOB
1666 K Street, NW
Washington, DC 20006-2083

Re: PCAOB Rulemaking Docket Matter No. 008

Gentlemen:

The proposed standard on auditing internal control is an ambitious attempt to forge comprehensive standards under the time pressure of a Sarbanes-Oxley-imposed deadline and the PCAOB is to be commended on the attempt. However, while the draft is an excellent approach to implementation guidance, it tries to accomplish too much. It attempts to set standards, make recommendations, suggestions and observations, and provide examples regarding auditing internal control; set standards for a financial statement audit; and even set standards for management.

To be successful the standard must be consistently read, understood, and implemented by practitioners, which requires a clear conceptual cohesiveness that establishes as standards only those matters that are critical to the public interest. Including additional implementation guidance, as this does, lengthens the document and diffuses the message, raising the risk that practitioners will view it as a list of procedures rather than the core of a professional service. Accordingly, I suggest the draft be pared back to those elements that are necessary for standards for audits of internal control. This would allow readers to focus on the important issues involved and allow the PCAOB to direct its full attention to setting this important standard.

Scope of the Standard

The draft proposes to establish a lot of standards in addition to the core issue. Unless you have a highly effective plan for issuing, codifying, and cross-referencing the standards, there is a significant danger practitioners will not find or focus on these new requirements. For example,

- The discussion of independence in ¶ 33-34 seems out of place here. I'm not sure a practitioner would ever think to look for a discussion of independence in this standard. If this is intended merely to reiterate rules contained elsewhere, it is redundant.
- Paragraph 139 amends SAS No. 56, with absolutely no rationale for the change has no connection with an audit of internal control. It appears to change the requirements

for analytical procedures only for auditors who are also reporting on internal control. I think practitioners are unlikely to realize it is here.

- Paragraph B32 adds requirements to those already in SAS No. 70. Again, the need for the change is not clear and the placement of this requirement will not make it readily apparent.
- Paragraph 138 is subtly, but significantly, different from SAS No. 55 (as amended) without explanation or justification.
- The illustrative combined report in Appendix A-6 indicates that audit reports will no longer refer to GAAS. This seems to be a significant issue that users would be interested in commenting on. However, the draft does not draw attention to this provision or to the implicit revision of SAS No. 58. It's also not clear why the change is necessary. One possibility is to differentiate the PCAOB's standards from AICPA-issued GAAS. But, of course, both FASB and GASB standards are called GAAP without any apparent confusion.
- Paragraphs 33, 173, and 184 all seem to set standards for management, which would appear to be beyond PCAOB's authority.

Criteria

The draft calls for the use of a suitable framework, consistent with the existing attestation standards. But then it calls into question how one judges suitability.

It says the COSO framework is suitable but then adds criteria not found in COSO, suggesting COSO doesn't meet the completeness attribute in ¶ 12. The specific audit committee requirements in ¶ 57 and the documentation requirement in ¶ 43 do not appear in COSO. The draft calls a failure to adhere to the additional requirements a deficiency, which is described in the report as a failure to comply with COSO even though COSO does not specify them.

The draft (¶ 13) says that other criteria might also be suitable. In fact, the PCAOB apparently has identified other suitable criteria ("other suitable criteria have been published…") but has chosen not to tell us what they are, leaving it to the auditor to figure out which ones have already passed muster. It would be more helpful if the draft explicitly named the suitable criteria. Instead, the auditor has to judge other criteria using the attributes articulated in the draft. Two of the attributes as described are likely to cause problems:

- The criteria must be published by a body of experts that followed due process procedures, including the broad distribution of the framework for public comment. The requirement for broad distribution, which had been in SSAE No. 1 was dropped in SSAE No. 10. Ironically, one of the considerations was a concern as to whether the distribution of the COSO draft was sufficiently broad to fulfill this requirement. It is also difficult for a practitioner after the fact to determine how broadly a draft was distributed by the body of experts. It also raises other questions, such what does distribution mean? Simply making something available on the internet is not the same as distributing it.

- The criteria have to encompass, in general, all the themes in COSO in addition to being sufficiently complete (the third bullet in ¶ 12). COSO identifies components, objectives, factors, issues, and points of focus. But I don't know what the themes are. The draft should direct the reader to them so the practitioner can determine if all the themes are addressed.

Internal Control Deficiencies

The concept of significant deficiencies is problematic. A deficiency (¶ 7) is a factor that does not allow (that means, I suppose, *prevents*) management from preventing or detecting misstatements on a timely basis. The examples in appendix B do not prevent the entity from achieving its objectives, but merely don't ensure it. I suspect this paragraph meant something like "does not assure prevention or detection." Paragraph 8 defines *significant deficiency*, saying it "could be [a single deficiency or combination of deficiencies] that results in more than a remote likelihood that a misstatement … that is more than inconsequential in amount will not be prevented or detected." I suspect the use of "could be" was meant to indicate that the deficiency could be either single of a combination, but as written it says that it could be something that results in an undetected misstatement.

Beyond these editorial matters, however, there are significant conceptual questions about characterizing deficiencies.
- Effective internal control only yields reasonable assurance—that is, a relatively low risk that material misstatements will not be prevented or detected on a timely basis. On the other hand, the borderline for significant deficiency is remote possibility, which I interpret to be far less likely than reasonable assurance. (The draft takes one term from the auditing literature and another from the accounting literature, making comparability difficult.) Combining this with an extraordinarily low materiality cutoff, inconsequential, substantially lowers the threshold. The goal of effective internal control, then, is an acceptable level of risk that's a quantum level above significant deficiency. This suggests a level of control far beyond what anyone would design to achieve reasonable assurance. I imagine that there are few controls that, based on this definition and the level of work done to assess it, wouldn't have a significant deficiency. I wonder if drawing the audit committee's attention to weaknesses at the bottom of this level will improve financial reporting or create an unnecessarily distraction.
- Paragraph 191 would create communications responsibilities for deficiencies that don't rise to the level of significant. It's hard to imagine the public interest that is served by mandating written communications of deficiencies that represent only remote risks, inconsequential amounts, or both.
- The concept of combining deficiencies is alluded to, but not explained. For multiple deficiencies to be combined, do they all have to deal with the same account? The same assertion? If various minor problems in different areas of the financial statements all failing at once would significantly misstate the financial statements is that a significant deficiency or material weakness? Example D-3 in the appendix does

not shed significant light on this. That example is really just a single weakness with no compensating controls.

- Paragraph 46 says that inadequate documentation of control is a deficiency. I don't see how that follows from the definition in ¶ 7 or the criteria in COSO. It goes on to say that this might also be a scope limitation, though there is no indication of what would go into that decision.

Walkthroughs

The section beginning at ¶ 79 presents a list of detailed requirements for walkthroughs. I'm not sure why this has been elevated to such a level of importance. I certainly agree that walkthroughs are helpful and, in general, a good thing. And the requirement exists in the current SAS No. 55. But the rationale for its inclusion in the SAS does not apply here. In SAS No. 55 the auditor might do no more than obtain the understanding of internal control. If no testing is done, the auditor has done nothing to confirm that understanding unless the auditor does walkthroughs. In an audit of internal control, however, there will be a substantial level of testing; in fact all of the important controls will be tested, which will confirm the auditor's understanding. Also, in the context of SAS No. 55, the auditor's documentation of controls might be the only place they are actually written down, so the walkthrough helps make sure the description is accurate. In audits of internal control, management has already documented and assessed internal control, making this step much less imperative.

Accordingly, I think this set of requirements places an unnecessary requirement on the engagement. Further, the language is unnecessarily onerous. Paragraph 80 says the walkthrough should be sufficient to "*determine* whether the processing procedures are performed as originally understood and on a timely basis" (emphasis added). My conception of a walkthrough would be insufficient to accomplish this; only a test of controls would be enough. Paragraph 81 dictates specific questions and suggests to whom they should be directed and what order to ask them. While helpful in an implementation guide, this guidance is unjustified as a standard.

Requirement for the Financial Statement Audit

Question 2 to your transmittal letter asks whether it is necessary to do the financial statement audit to audit internal control. As I read Sarbanes-Oxley it seems to require that they be done as a combined service ("shall not be the subject of a separate engagement"). If, however, you have determined that it is legal to separate them, I see no reason for the requirement, although economics and practicality will probably drive practice to combine them. In practice, it is likely that many firms will assign different staffs to the two services either for efficiency or competence considerations. If the firm uses two sets of auditors for the two services each team will have intimate knowledge only of its engagement and will have to communicate certain matters to the other to make sure important items are considered. I expect they would formally communicate control weaknesses, misstatements, fraud or illegal acts, and other audit committee-type communications. If two auditing firms coordinated in the same manner there would be no loss of effectiveness.

Other Matters

There are a number of other issues of more-than-editorial concern:

¶	Comment
24	The second and fourth bullets are not elements of the control environment. Neither are many of the controls that comprise the first bullet.
26	This paragraph introduces the concept of fraud identification. How is identification different from detection? What additional controls are envisioned here?
41	Management is allowed to rely on the work of the service auditor in fulfilling its responsibilities. What if the auditor is also the service auditor? Is the auditor then auditing his or her own work when considering management's assessment? Would the independence rules described in SAS No. 70 still apply?
61	The ramifications of the second half of this paragraph are unclear. It seems to suggest that a material weakness could exist in an account in which there could not be a quantitatively material misstatement. Thus, the implication is that the auditor is concerned with designing procedures to detect misstatements that are only qualitatively material. (Although it speaks only to controls over certain smaller accounts, it is hard to argue that the concept is much different.) This is a stark departure from SAS No. 47.
75	The linkage requirement implies, but does not state, a specific documentation requirement. This should be clarified.
93	This paragraph provides a real-life problem, but the solution in the final sentence doesn't solve it. Reperforming the control does not provide evidence that the supervisor performed the necessary review, which was the control to be tested. It only shows the auditor would have approved it.
101	The paragraph requires the auditor to vary the nature, timing, and extent of tests of controls each year. I'm not sure this improves the quality of the service. If the extent of tests is appropriate in one year, to change it the next year would require the auditor to do insufficient work or to over-audit unless the nature of the tests also changed. But of course, the type of control generally dictates the nature of the test, so changing that might provide a less effective test. Increasing the extent of a less-effective test seems an inefficient, and possibly less effective, approach to require. The example in the paragraph also seems to confuse the time period tested with the timing of the test. I understand the concern this paragraph was trying to address, but I think the requirement seems unduly inflexible. Perhaps the goal can

¶ Comment

be accomplished by warning auditors against too much predictability in choosing time periods, locations, and the like.

105 The second bullet implies the auditor has assessed the risk of control failure (that is, effective design but ineffective operation). The standard should refer to where it discusses such an assessment of individual controls. How does one judge this? Is it based solely on the results of tests of the controls (that is, a high deviation rate) or other things, such as complexity or subjectivity. (The discussion in ¶119 talks about risks in a different context—identified deficiencies—but perhaps some of the same concepts might apply here.)

126 The auditor's discovery of a material misstatement is described as a "strong indicator" of a material weakness. I think this doesn't go far enough. A material misstatement should be presumed to be the result of a material weakness. The auditor should have to justify any conclusion that it isn't.

140 The last sentence is not universally true. There are many times that analytical procedures are more effective in finding fraud than looking at the details, particularly when the completeness assertion is involved. (Analytical procedures might not be adequate for quantifying the fraud once it is detected, though.)

146 This paragraph confuses some concepts. Control risk is defined only in the context of audits of financial statements, not in the audit of internal control. (Actually, in this context control risk would reasonably refer management's assessment of its controls.) So, it's unclear whether this is talking about the financial statement audit or the audit of internal control. Further, under the existing SASs, control risk is assessed for assertions, not, as suggested by the second sentence, account balances.

I would be happy to discuss these comments with you in more detail if you'd like.

Sincerely,

PEARSON

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Ref: PCAOB Rule Making Docket Matter No. 008

Proposed Auditing Standard - An Audit Of Internal Control Over Financial Reporting Performed In Conjunction With An Audit Of Financial Statements.

Dear Sirs,

We have reviewed the proposed auditing standard noted above and wish to comment on them.

Firstly, as a publicly quoted company, with listings in both London and New York, we support all sensible and effective steps made to improve company corporate governance and the open disclosure of material information, both financial and non-financial, to shareholders and other interested parties.

As you will be aware, many of the principles recommended under the Sarbanes-Oxley Act, and subsequent SEC rules, have been in place in the UK for several years as requirements of the UK Stock Exchange Combined Code, with which we comply.

We are concerned that the proposals, in their current form, will add significant costs, through additional external audit fees and internal compliance costs, for limited improvement in our existing corporate governance and financial reporting internal control environment, and therefore will provide little or no added value to our shareholders. In fact, we believe there is a risk that the proposed, extremely detailed auditing requirements may lead to a deterioration in the effectiveness of corporate governance as both auditors and management seek to comply with detailed rules at the expense of focusing on the fundamentals.

We welcome the overriding principle that external auditors should review and comment on financial reporting internal controls. We believe that the external auditor can most effectively evaluate the financial reporting internal control environment by focusing on high level entity controls and conducting more detailed evaluations where these controls have failed, appear to be failing or relate to high risk transactions or processes. We also believe greater reliance can be placed on the management's own control processes and reviews, e.g. internal audit, than suggested in this draft standard.

As requested, we have responded to the thirty-one questions you posed. Please see the attached appendix.

We hope you will consider these points favorably in your deliberations and that they will assist you in drafting an appropriatc, effective standard which contributes to the improvement in corporate governance and financial reporting in the USA.

Yours sincerely,

Rona Fairhead
Chief Financial Officer

Specific Comments

In making specific comments, we have followed the numbering sequence used in your release number 2003-017 dated October 7, 2003.

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?

   We believe it is.

2. Should the auditor be prohibited from performing an audit of internal controls over financial reporting without also performing an audit of the financial statements?

   We believe it is generally more effective and efficient that the auditor perform both audits, which are closely linked. Any audit of financial statements should take account of the financial reporting internal controls which generate the numbers included in the financial statements.

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?

   We believe that both audits are linked. Integrating them minimises costs.

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?

   Not applicable to our multinational organization.

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?

   We believe that the existing professional standards suffice. The competency of staff used should be left to the judgment of the external auditor taking into account the risks associated with and the complexity of any specific assignment.

6. Is the scope of the audit appropriate in that it requires the auditor both to evaluate management's assessment and obtain, directly, evidence about whether internal control over financial reporting is effective?

   We believe it is appropriate, but the key is for the methodology to allow this to be done in a cost effective and practical manner.

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

   We believe it is.

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?

   We do not believe that inadequate documentation in its own right is necessarily an internal control deficiency. Controls can be in place and operating effectively without being documented. The auditor should be verifying whether a "real" deficiency exists. Control documentation assists both management and the auditor in reviewing the controls, documentation in and of itself is not an internal control.

   Inadequate documentation should not automatically give rise to either a significant deficiency or a material weakness.

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

   General point: The issues addressed by questions 9 – 16 all relate to the amount of detailed work that the auditor must conduct to satisfy him/herself that an effective financial reporting control environment exists to support management's 404 conclusion.

   We support the principle of the auditor's role in this area, however, the proposed requirements are extremely detailed and appear inflexible in both their structure and application. No account seems to be taken of the cost-benefit of your proposed approach, either from the auditor's or the management's perspective. There is a risk that, rather than being in the shareholders' interest, the level of detail required will have the opposite effect – higher cost to implement and more "box ticking" rather than a more effective evaluation of a company's financial reporting internal control environment.

As with any audit, the amount of work required to form an opinion is dependent on the risks and complexity of the business and the business processes being audited. Therefore, we believe that guidance on the general principles for evaluating financial reporting internal controls rather than the prescriptive approach suggested would be better. This would allow the auditor, within a laid down framework, to exercise his/her own judgment on the amount of work to be carried out to evaluate the effectiveness of the financial reporting internal controls and management's conclusions.

Although we believe that auditor walkthroughs may be appropriate in certain circumstances, we believe walkthroughs are just one technique for evaluating internal controls. Auditors should be given the flexibility to determine the audit scope and should be able to rely on other sources to confirm that controls are effective; these would include management's control reviews and prior year work.

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 9 above. Wherever possible, the auditor should be allowed to use walkthrough work performed by others, subject to his/her comfort with the quality of the work completed by the other party.

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?

    Where appropriate the auditor should use evidence from prior years to support their current opinion on management's assessment.

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

    As previously stated we believe the auditor should be permitted to use the work of management and others whenever they feel that this work has been performed to satisfactory standards and can be relied upon. In higher risk areas, e.g. treasury transactions, it may be appropriate for the auditor to do some limited testing to validate management's and other's work.

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

We believe these definitions are too restrictive. The risk of fraud exists in any financial system; a literal interpretation of this definition would imply that the auditor would need to audit every financial accounting process/system. A better approach might be to allow the auditor to exercise judgment on what to audit and whose work can be relied on to meet individual circumstances. General guidance on the principles to be applied would be more helpful.

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?

We do not believe it does. The external auditor should be encouraged to rely on the work of internal audit, which generally covers many of the issues addressed, as far as possible, subject to general agreement on the methodology, including testing, adopted by internal audit.

15. Is the flexibility in determining the extent of re-performance of the work of others appropriate, or should the auditor be specifically required to re-perform a certain level of work (for example, re-perform tests of all significant accounts or re-perform every test performed by others that the auditor intends to use)?

We believe there should be flexibility in determining the extent of re-performance of work.

16. Is the requirement for the auditor to obtain the principal 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?

The auditor needs to obtain enough evidence either from his/her own work, or the work of others, to satisfy him/herself that management's conclusions are reasonable.

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?

Clear definitions of significant deficiency or material weakness are definitely needed and will provide consistency in the evaluation of control deficiencies.

In defining a significant deficiency the terms "remote likelihood" and " is more than inconsequential" are extremely subjective and difficult to interpret. Some materiality guidance would be helpful e.g. financial results could be misstated by x%. As presently defined even a minor control weakness could be interpreted as a significant deficiency.

In defining internal control deficiencies, greater account should be taken of whether the deficiency has actually resulted in an internal control breakdown and misstatement in the financial reporting, as compared to a deficiency that exists but is unlikely to result in a financial reporting misstatement due to compensating controls.

In defining deficiencies that remain uncorrected after some reasonable period of time, consideration should be given to the complexity of the underlying system(s) and the existence of a project plan to address such deficiencies.

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 commentators could suggest that would provide further interpretive help?

    Yes. Additional examples would be helpful.

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

    We believe it is.

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. This should be a part of the existing standard reporting of audit findings by the auditor; this is standard practice in the UK.

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

    We believe they are.

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?

    We believe so, but general guidelines should be provided.

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

    We believe so, if guidelines are provided to all concerned including the Audit Committee.

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?

    We do not believe so. Any concerns over the effectiveness of the Audit Committee should be promptly reported to the full Board, and the shareholders as part of the auditor opinion.

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?

    Yes.

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

    We believe an exception should be allowed for acquisitions completed close to or at the end of a reporting period. It may be impractical to evaluate the effectiveness of financial reporting internal controls of acquisitions completed close to the year end, despite due diligence work carried out as part of any acquisition appraisal/decision. Unquoted businesses and non-US acquisitions may be a particular problem as these businesses may not be compliant with the requirements of Sarbanes-Oxley. Additional post acquisition work may be required to bring any control deficiencies up to US/UK public company standards.

27. Do you agree with the position that when the auditor issues a nonstandard 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?

    The auditor's opinion should speak to both the effectiveness of internal controls over financial reporting and, where appropriate, whether management's assessment is fairly stated. If they speak to the latter they should provide adequate explanation of the basis for their opinion.

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

    We believe it should.

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

    We do not believe so providing the auditor is not auditing his/her own work.

30. Are the auditor's differing levels of responsibility as they relate to management's quarterly certifications versus the annual (fourth quarter) certification, appropriate?

    No comment -- we are a foreign private registrant.

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

    No comment – we are a foreign private registrant.

PENN VIRGINIA CORPORATION
Three Radnor Corporate Center • Suite 230
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November 21, 2003

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20002-2803

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.

Dear Board Members:

Penn Virginia Corporation (NYSE: PVA) is an energy company engaged in the exploration, acquisition, development and production of crude oil and natural gas. Through its ownership in Penn Virginia Resource Partners, L.P. (NYSE:PVR), PVA is also in the business of managing coal properties and related assets. As of November 14, 2003, PVA had an equity market capitalization of approximately $415 million. As a small market capitalization entity, PVA has a limited staff and is a very cost-conscious organization.

I appreciate the research and efforts of the Public Company Accounting Oversight Board regarding the proposed auditing standard, An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements. I understand the need to provide regulations that serve to increase the public's confidence in the financial markets. However, <u>I believe compliance with your Proposed Auditing Standard as applied to small entities like PVA will result in onerous cost increases that will greatly exceed any derived benefits</u>.

PVA's efforts to comply with SOX began shortly after its enactment in 2002. To date, we have implemented comprehensive and detailed quarterly and annual reviews of our accounting disclosures and we have documented most of our processes. While we expected costs to increase due to SOX, we were surprised and dismayed by the projected increase in auditing fees related to the "internal control audit" (estimated by our auditors to be 25% to 50% of our annual financial statement audit fee) and on the resultant need for ongoing documentation updates and auditing certifications. It also appears that much of what we have been doing to document and test our processes will be disregarded and must be repeated by our auditors, since the Proposed Standard states that there are a number of significant areas "in which the auditor should not use the results of testing performed by management" (Page 38, paragraph 104).

I do not believe the audit and related costs are justified for an entity of our size, since much of the business is adequately controlled by a "top-down" emphasis on cost management and control awareness. Furthermore, I do not believe that the "internal control audit" will provide any practical benefit to the investors in PVA. Rather, the investors will be hurt far more by the incremental cost of compliance than they will benefit by the added certification that the internal control systems are functioning properly. I believe that PVA's investors and investors in other public entities are far more concerned that the financial statements are accurate and provide full disclosure. A company's internal controls are one of several processes used to support those financial statements. The controls ultimately depend on the integrity of management, the audit committee and the board, and not on an onerous, overly formal auditing requirement that would result in the "form" of documentation becoming more important than the "substance" of the control environment. As opposed to a separate "internal control audit", I believe the public accounting profession should comply with current auditing standards by performing internal control testing to the extent necessary to establish the level of validation work needed to confidently express an opinion on the financial statements of the registrant.

I agree with the views expressed by Robert Schneider of Kimball International Inc. in his October 16, 2003 letter to you and by Dennis Stevens' of the Alamo Group in his November 4, 2003 letter, both of which are posted on your website.

I strongly urge you to reconsider your requirement for an "internal control audit" and suggest you consider the changes suggested in Mr. Stevens' November 4 letter, including a way to limit the liability of the auditor if they can show that they satisfied their responsibilities as defined by the PCAOB. I urge you to try to arrive at a more cost effective solution than the Proposed Standard in its current form.

Sincerely,

Frank A. Pici

Frank A. Pici
Executive Vice President and
Chief Financial Officer
Penn Virginia Corporation

PENN VIRGINIA RESOURCE PARTNERS, L. P.

November 21, 2003

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20002-2803

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.

Dear Board Members:

Penn Virginia Resource Partners, L.P. (NYSE: PVR) is a master limited partnership (MLP) formed by Penn Virginia Corporation (NYSE: PVA) to manage coal properties and related assets. In addition to the coal business, PVR generates revenues from the sale of timber growing on its properties. As of November 14, 2003, PVR had an equity market capitalization of approximately $610 million. As a small market capitalization entity, PVR has a limited staff. Furthermore, as an MLP, PVR pays most of its cash flow to its unit holders in the form of cash distributions. As such, the cost versus benefit of all administrative expenses are closely controlled and scrutinized.

I appreciate the research and efforts of the Public Company Accounting Oversight Board regarding the proposed auditing standard, An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements. I understand the need to provide regulations that serve to increase the public's confidence in the financial markets. However, I believe compliance with your Proposed Auditing Standard as applied to small entities like PVR will result in onerous cost increases that will greatly exceed any derived benefits.

PVR's efforts to comply with SOX began shortly after its enactment in 2002. To date, we have implemented comprehensive and detailed quarterly and annual reviews of our accounting disclosures and we have documented most of our processes. While we expected costs to increase due to SOX, we were surprised and dismayed by the projected increase in auditing fees related to the "internal control audit" (estimated by our auditors to be 25% to 50% of our annual financial statement audit fee) and on the resultant need for ongoing documentation updates and auditing certifications. It also appears that much of what we have been doing to document and test our processes will be disregarded and must be repeated by our auditors, since the Proposed Standard states that there are a number of significant areas "in which the auditor should not use the results of testing performed by management" (Page 38, paragraph 104).

Three Radnor Corporate Center • Suite 230 • 100 Matsonford Road • Radnor, PA 19087-4515 • 610-687-8900 • Fax 610-687-8900
fpici@pennvirginia.com • www.pvresource.com

I do not believe the audit and related costs are justified for an entity of our size, since much of the business is adequately controlled by a “top-down” emphasis on cost management and control awareness. Furthermore, I do not believe that the “internal control audit” will provide any practical benefit to the investors in PVR. Rather, the investors will be hurt far more by the incremental cost of compliance than they will benefit by the added certification that the internal control systems are functioning properly. I believe that PVR’s investors and investors in other public entities are far more concerned that the financial statements are accurate and provide full disclosure. A company’s internal controls are one of several processes used to support those financial statements. The controls ultimately depend on the integrity of management, the audit committee and the board, and not on an onerous, overly formal auditing requirement that would result in the “form” of documentation becoming more important than the “substance” of the control environment. As opposed to a separate “internal control audit”, I believe the public accounting profession should comply with current auditing standards by performing internal control testing to the extent necessary to establish the level of validation work needed to confidently express an opinion on the financial statements of the registrant.

I agree with the views expressed by Robert Schneider of Kimball International Inc. in his October 16, 2003 letter to you and by Dennis Stevens’ of the Alamo Group in his November 4, 2003 letter, both of which are posted on your website.

I strongly urge you to reconsider your requirement for an “internal control audit” and suggest you consider the changes suggested in Mr. Stevens’ November 4 letter, including a way to limit the liability of the auditor if they can show that they satisfied their responsibilities as defined by the PCAOB. I urge you to try to arrive at a more cost effective solution than the Proposed Standard in its current form.

Sincerely,

Frank A. Pici

Frank A. Pici
Vice President and
Chief Financial Officer
Penn Virginia Resource Partners, L.P.

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From: dave.harrison@pentair.com
Sent: Tuesday, November 25, 2003 5:49 PM
To: Comments
Cc: fholman@mapi.net
Subject: PCAOB Rulemaking Docket Matter No. 008

Mr. William J. McDonough, Chairman
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 008,
Release No. 2003-017, October 7,2003

Dear Mr. Chairman and Members and Staff of the Board:

In response to the PCAOB Rulemaking Docket Matter No. 008, Pentair and I would like to express our concurrence with the Manufacturers Alliance/MAPI letter dated November 21, 2003, attached. In particular, the PCAOB proposal is unnecessarily prescriptive and will be very costly to Pentair and other companies that fall under its requirements while providing minimal benefits at best. The proposal requires the external auditor to perform many procedures directly without assistance of competent company employees under the direction of management. Also, the proposal requires that many procedures be done annually without regard to risk or allowance for the use of sampling or cycling.

During 2003, Pentair will have spent $1.5 Million implementing the requirements set forth in the Sarbanes/Oxley Act. This amount does not include the extra yearly costs anticipated to continually monitor compliance to Sarbanes/Oxley legislation, nor does it include the yet to be determined external audit costs for yearly attestation by the external auditors or the fees levied by the PCAOB to fund your organization. In total, it will cost Pentair several million dollars each year to abide by the new legislative requirements. These are costs that directly effect our bottom line and therefore our ability to provide new jobs and higher investor returns. It is unfortunate that a few "bad" public companies have caused such an overreaction and that now we all must pay for their indiscretions with more legislated requirements.

Pentair thanks the PCAOB for this opportunity to comment on Rulemaking Docket Matter No. 008. We hope that the final requirements become less intrusive to all companies and that there eventually is a better balance between internal personnel and the external auditors in fulfillment of the Sarbanes/Oxley requirements.

David Harrison
Executive Vice President and Chief Financial Officer
Pentair, Inc.

From: Perisho, Jim [perisho@ptlr.com]
Sent: Sunday, October 26, 2003 2:56 PM
To: Comments
Subject: Proposed Auditing Standard-Audit of Internal Control

Significant Deficiency vs Material Weakness

The definitions in paragraph three on page eight of the Briefing Paper don't make sense. Both significant deficiencies and material weaknesses are defined as "…more than a remote likelihood of a misstatement of/in the company's annual or interim financial statements." Are you saying they are the same?

James C. Perisho, CPA
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* * * *

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Loretta V. Cangialosi
Vice President and Controller

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, Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements***

Ladies and Gentlemen:

Thank you for allowing Pfizer the opportunity to comment on the proposed professional standards as drafted by PCAOB to govern the independent auditor's attestation, and reporting on, management's assessment of the effectiveness of internal control.

Pfizer is a research-based global pharmaceutical company that discovers, develops, manufactures, and markets innovative medicines for humans and animals. Earlier this year, Pfizer completed its merger with Pharmacia Corporation, another global pharmaceutical company. After the acquisition, pro forma revenues of the combined company will approximate $45 billion and pro forma assets of the combined company will approximate $120 billion.

We fully support the PCAOB as they establish themselves in their private-sector role to oversee the auditors of public companies in order to protect the interests of investors and to further the public interest in the preparation of informative and independent audit reports. Further, we appreciated the opportunity to participate in PCAOB's July 29 'Roundtable' discussions regarding the proposed standard. In those discussions, we were heartened by the strong consensus among all constituents with regard to the following:

- The standards should be 'principle-based' vs. 'rule-based.
- There is no escaping that it still comes down to the auditor's application of judgement, i.e. 'one size fits all' was unanimously deemed to be inappropriate in the context of this standard. It is impossible to devise a complete set of rules covering all circumstances. Just as it does in the financial statement audit, it must come down to the auditor's judgment.

- There has to be a balance in the interpretation of the amount of external auditor work required to attest to management's assertion over the effectiveness of internal controls over financial reporting. There was solid agreement that the external auditor should not "principally" rely on the work of management/internal audit in completing their attestation. However, there was also clear agreement that the Internal Audit function was an important part of the internal control environment and could be relied upon to an appropriate extent if the external auditor was satisfied with their assessment of the objectivity and competence of that function.

We feel that the proposed standard deviates from that consensus in several areas. Below are those areas we feel the Board should review, and then recommit to the consensus.

The Intended Scope of the Attestation

From the outset, Section 404 (b) of the Sarbanes-Oxley Act specified that the external auditor "shall attest to, and report on, the assessment made by the management of the issuer." However, the proposed standard deviates from that requirement by suggesting that the external auditor must audit the entire internal control environment, thereby extending the intended requirement. This would require significantly more work by the external auditor with little incremental benefit over an attestation of management's assessment, the intended requirement. We do not believe the premise that such a robust undertaking actually achieves its intended result, higher comfort by the investor community. In fact, we feel this proposal may increase the auditor expectation gap relative to investors who are likely to deem this as a certification that there is no possibility of fraud. It will be almost impossible for external auditors to achieve the expected audit of the entire internal control environment.

We strongly believe that the Board should revert to the intended requirement of an attestation of management's assessment, protecting the credibility of that attestation. Companies need to be allowed to practice good governance and demonstrate a respect for compliance, rather than have guidance so complex it, compromises the credibility of the standard-setting process. If actual practice indicates a need for further guidance, it should then be considered.

Using the Work of Management and Others

The proposed standard offers specific guidance for auditor testing around 'significant transaction streams' and conducting 'walkthroughs'. And it specifically limits the auditor's use of work performed by management and internal audit in other key areas, e.g. controls over IT and reserve estimates. We feel the specificity of guidance in this area not only runs counter to the notion of the auditor using judgment in the execution of their duties, it begins to frame out a dangerous 'check the box' approach to attestation. It was agreed at the July Roundtable that "one size does NOT fit all", and we therefore continue to believe that such a mandated, uniform and specific approach which does not permit an auditor to use judgment is inappropriate.

The Internal Audit function has been identified in COSO and other mediums as a critical component of the internal control environment. The recently-approved NYSE listing requirements include an Internal Audit function. And, increasingly, Audit Committees are realizing an important asset in effective oversight is a competent, objective internal audit function with a good reporting relationship to them. By restricting the auditor's reliance on internal audit's efforts to routine transaction processing, the appeal of that function is dulled. That would contribute to a weakening of the function, clearly an unintended consequence to the Audit Committee. Again, the external auditor must be allowed to assess the competence, effectiveness and objectivity of the Internal Audit function and to exercise judgment in the conduct of their attestation program, including the extent to which they may rely on internal audit work.

Evaluation of the Effectiveness of the Audit Committee

The proposed standard provides that the auditor should evaluate the effectiveness of the Audit Committee's oversight of the company's external financial reporting and internal control over financial reporting as a part of its attestation. Given the Audit Committee's express obligation to retain, compensate and terminate the auditor, this evaluation requirement appears circumspect. Further, most Big 4 audit firms have a process by which the audit engagement partner and team are evaluated by Audit Committee members as a quality check. In this case, you have the Audit Committee evaluating the external auditor and deciding on the external auditor service and compensation and the external auditor evaluating the Audit Committee. This type of circular arrangement is the reason that Sarbanes Oxley saw fit to take the engagement of the external auditor away from management. Aside from the obvious conflict of interest, it's questionable whether auditors may have all the requisite skills to make such an evaluation. While external auditors have contact with many audit committees it does not mean that they have any in-depth knowledge or expertise in making a judgment on the effectiveness of the Audit Committee.

After taking so many positive steps in helping to re-establish auditor independence, we strongly urge you to delete such a specific evaluation of the Audit Committee by the auditor. We would suggest that Governance Committees of the Board of Directors already play an effective role in any evaluation of the Audit Committee. The Board is free to make those evaluations as they deem appropriate, including any direct contact with the auditor. Indeed, it may be appropriate to underscore the Board's obligations in that regard, rather than allow them to passively delegate their oversight role to the auditor.

Significant Transaction Stream Inclusion

The proposed approach focuses on significant transaction streams rather than focusing on the significant risk issues associated with financial failures. An audit approach that does not allow application of an auditor's judgment or take into account the relevant risk factors will not produce better or more reliable attestation reports for investors. For example, the current proposal would require auditors to 'walkthrough' the Payroll process as it is a significant transaction stream. However, in our industry, it is highly improbable that 'walkthroughs' and testing in this area would result in the detection of any kind of material weaknesses or misstatements.

We believe more significant risk events include:

- Wrong tone at the top
- Significant business model changes
- Rapid growth over a short period of time
- A change in the sales terms or changing revenue streams
- Compliance, regulatory or litigation issues
- Unusual or new accounting or structural transactions
- Reserves or accruals where significant judgment is required

Auditors must understand the overall control environment and the potential risk issues. To this end, we suggest a more principle-based approach that would allow auditors to exercise appropriate judgment in deciding which areas require 'walkthroughs' and related testing.

Control Documentation Guidance

The Standard focuses on using "textbook" methods to assess internal controls, including expectations for documentation of all controls. Given that global companies are dynamic in nature and ever changing, current and comprehensive documentation would present an excessive burden, which we believe exceeds the intentions of the legislation. In addition, today's companies rely heavily on technology for controls focused both on prevention and detection, which are often embedded in the supporting information systems rather than documented on paper copy. Companies utilize significant analytical techniques today to understand their results and monitor the way in which financial results are being reported. For example, many companies have dashboards to show daily sales by product of store location. The internal controls methodology adopted in the final rules must consider these more "cutting edge" types of control activities. Again, we believe that permitting auditors to exercise more judgment would permit them to make the most appropriate tests in the circumstances.

In conclusion, we share the same goal as the PCAOB, maintaining and strengthening the integrity, quality and transparency of financial statements. However, we believe the proposal has introduced significant unintended consequences. We strongly recommend that the final rules reflect the good consensus obtained as part of PCAOB's process of standard setting, i.e. the notion of principle-based, auditor judgement and 'balance'.

We appreciate your consideration of these comments. We would be happy to discuss these matters further or to meet with you if it would be helpful.

Sincerely,

Loretta V. Cangialosi

Loretta V. Cangialosi
Vice President and Controller

cc:

David L. Shedlarz
Executive Vice President and Chief Financial Officer

Hugh Donnelly
Vice President- Internal Audit

Peggy Foran
Vice President, Corporate Governance
& Corporate Secretary

PIERCY BOWLER TAYLOR & KERN
Certified Public Accountants • Business Advisors

November 20, 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

Ladies and Gentlemen:

We appreciate the opportunity to comment upon the proposed auditing standard contained in Release No. 2003-107 with regard to the independent auditors' responsibilities under Sec. 404 of the Sarbanes-Oxley Act of 2002 and related regulations. The proposed standard apparently represents the result of substantial analysis and consideration of many issues concerning auditors responsibilities and users' needs in this newly expanded area of financial reporting and the attest function.

Because of the comprehensiveness and sheer volume of the proposed standard and the relatively short comment period, rather than directly addressing the 31 questions posed by the Board in its 25-page letter accompanying the draft standard (which we will leave to other commentators with greater resources), we will necessarily limit our comments to those few matters we believe to represent significant inherent inconsistencies or potential conflicts in, or likely to be caused by, the standard, if adopted as proposed, and other issues most seriously, in our opinion, in need of reconsideration by the Board.

The principal inconsistency we see in the proposed standard relates to the long-accepted premise underlying the definition of *internal control over financial reporting* set forth in paragraph 6, and virtually all other similar definitions that have appeared in our authoritative literature throughout the institutional history of the auditing profession. That is, that internal control can only provide reasonable, but not absolute, assurance of achieving its objective of preventing or detecting misstatements or misappropriations of resources. The notion of reasonable, but not absolute, assurance, effectively acknowledges that misstatements and misappropriations (which could be material) can occur even in the presence of the strongest, most effective controls as a result of innocent human failures (for example, inadvertent errors, oversight or poor judgment) or collusion or management override. But in the face of these acknowledged facts of business life, the standard seems to abandon the notion of "reasonable assurance" by prejudging in paragraph 126 that the discovery of a material misstatement in the financial statements by the auditors must be reported at least as a significant deficiency and establishing an effective burden of justification if it is not reported as a material weakness. The same is true with regard to restatements of previously issued financial statements.

By prejudging the reporting implications of such events with respect to internal control reporting, the standard not only eliminates both the opportunity and obligation to exercise sound professional judgment based on facts and circumstances, but creates enormous potential for disagreement between management and the auditors (which disagreement would be separately reportable also under other provisions of the securities laws and regulations). We believe such unequivocal prejudgment at the standard level would likely cause a large number of smaller issuers to receive qualified or adverse opinions on internal control, for no reason other than the fact that the company's auditors are doing a good job in finding and proposing adjustments, thus severely impairing their future access to the capital markets and causing diminution in the value of the public shareholders' investments, event if the financial statements contained no material misstatements when issued. We do not believe this kind of reporting would be in the investing public's best interests.

We also believe that the definition of *internal control deficiency* in paragraph 7 should be revised to more closely mirror the definition of *internal control over financial reporting* in paragraph 6 by incorporating a reference to the notion of reasonable assurance. For example, the definition might be modified as marked in boldface type below:

> "An *internal control deficiency* exists when the design or operation of a control does not ~~**allow**~~ **reasonably assure that** management or employees, in the normal course of performing their assigned functions, ~~**to**~~ **will** prevent or detect misstatements on a timely basis."

Additionally, since they are the bodies most responsible for overseeing both management and the independent auditors, we regret that Sarbanes-Oxley did not place any regulatory oversight on audit committees, as it did for auditors by establishing the Board. But we believe any attempt (as in paragraph 126) to repair that omission by making auditors responsible to report publicly on the performance of the audit committees, sets up a serious conflict of interest for auditors since audit committees are responsible for their selection (hiring and firing) and performance evaluation. This kind of circular oversight would be, in our view, untenable in many likely circumstances.

Recognizing, as mentioned above (in the third paragraph of this letter) that, given the principle of reasonable assurance, even under the best controls, material misstatements can nevertheless occur for a variety of reasons, we have been concerned since Sarbanes-Oxley was finalized in 2002 that publicly distributed auditors' unqualified opinions on the effectiveness of internal controls (or the fairness of management's positive assessment) may lull investors into a false sense of security about the likelihood of a misstatement, particularly, those users who might tend to "zero in" on the opinion paragraph without reading the "inherent limitations paragraph" (as it is referred to in APPENDIX A) that precedes it in the illustrations. We suspect this concern contributed significantly to the failure of prior attempts by the SEC in 1979 and 1988 to require audit reports on internal control in public filings. We believe that our concern could be ameliorated by moving the language illustrated in the inherent limitations paragraph to the end of the opinion paragraph and connecting it with a transitional word such as "however." This would be more effective, we believe, in placing the unqualified opinion in proper perspective.

We hope we have clearly articulated our significant concerns about the proposed standard for your consideration. However, if there are any questions, please contact either of the undersigned.

PIERCY, BOWLER, TAYLOR & KERN

L. Ralph Piercy, President and
Managing Shareholder

Howard B. Levy, Principal and
Director, Technical Services
(Former member, Auditing Standards Board)

From: Zona Porter [zonaporter@yahoo.com]
Sent: Friday, November 21, 2003 2:09 PM
To: Comments
Subject: Modern Mobsters - Legalized Racketeering!

Public Company Accounting Oversight Board
Attention: Office of the Secretary
1666 K Street, NW
Washington, DC 20006-2803

RE: PCAOB rulemaking docket matter no. 008
Modern Mobsters – Legalized Racketeering

The accounting profession is an illegal racket. They operate like an organized crime syndicate and should be investigated for their illegal and corrupt business practices. These new "rules" you are passing are only going to further help them in what has become one of the greatest legalized ponzi schemes in our country's history.

While the rest of the economy works hard to recover from the most recent recession we are witnessing the accounting profession reap a bountiful harvest. They are reporting record revenue growth and project even more prosperous times ahead. Much of this thanks to two key events:

- The collapse of Arthur Andersen, and
- Organized price and scope increases.

It is appalling to see the new accounting oversight body is about to write regulations which will do nothing to prevent another Tyco, WorldCom, or Enron but only continue to enable the accounting profession to continue their organized scheme.

The new rules that you have proposed will do nothing but enrich the accounting profession. The proposed rules on internal controls will do nothing to prevent another Enron (Andersen), WorldCom (Andersen), Tyco (PWC), Adelphia (D&T), or HealthSouth (E&Y). They will only further enable the accounting Mafia to continue their shake down of Corporate America with their conspiracy to provide yet even more revenue-generating services.

These highly secretive private partnerships operate as an exclusive club of Mafia-like professionals. They are highly organized, secretive, and ruthless in their business dealings. Regulation and reform are necessary to stop this organized racketeering operation.

When Arthur Andersen was faced with the prospect of eminent bankruptcy following the criminal conviction of their partnership, the rest of the Family held a "special meeting" similar to the meetings Joe Bonanno organized for the American Mafia families. Joe Bonanno formed "The Commission" for Cosa Nostra. The Commission consisted of a council of the five top Mafia families. They would meet to arbitrate matters important to the "Family" business. The different families worked together to secretly protect one another and make sure that disputes could be resolved within the Family and the families various business dealings.

Likewise the Big Five (and now the Big Four) families have a similar structure. They regularly engage in discussions with their peers to ensure that their businesses (tax, internal audit, audit, etc…) and high returns are protected. Protected from government regulation. Protected from competitors. Protected from other threatening forces that may undermine their structure.

When Andersen was convicted, the rest of the Family got together to carefully divide up the remains. Andersen executives even participated in these meetings. Each firm agreed to take a certain share (not too much or too little) to make sure that "successor liability" would not jeopardize any of the remaining members. They worked out deals to make sure that many of the former Andersen partners were "taken care of" and remained in the "Family business". Sure some Andersen partners lost money – but very few became unemployed or filed for bankruptcy. Why? Because the Family took care of it's own.

The Big Four Commission also agreed to not raise (or decrease) prices. Instead they would bid jobs based on what Andersen had previously charged. This would ensure an orderly transition and prevent a bidding war for business. Each firm agreed how much to pay Andersen and how best to "buy a partner" and his/her book of business. The transaction was executed perfectly. No one complained. The FTC did not investigate. And each firm won a their fair share of a bigger pie.

This was also made possible by another Family tradition: Not to speak out against other Family members publicly or show disrespect for the Family (profession). The recent Finance Committee hearing on Illicit Tax Shelters looked more like a Mafia inquiry then a business inquiry. People were afraid to speak out. They even had a witness ("Mr. Janet" an anonymous pseudonym for someone who was too scared to speak publicly for fear of retaliation) behind a curtain with a disguised voice. Other witnesses who spoke out (e.g. Michael Hamersley, Robert Schmidt, and Thomas Walsh) all spoke about the fact that their careers and futures were ruined because they spoke out against the big firms.

People are afraid to talk, and why shouldn't they be? Their livelihood depends on the Big Four Mafia. To cross the Family can find someone in financial and career ruin. Big Four firms sue former employees who violate the code or quietly discredit former professionals or uncooperative clients to prospective employers. Meanwhile, Family members who play ball can be assured future opportunities including invitations to join corporate boards. The firms operate extensive "alumni networks" in order to provide referrals and other professional "courtesies" to loyal alumni. It doesn't stop there. Loyal clients who funnel business back into the Family are treated to lavish vacations and other entertainment perks like tickets to sporting events, theater and expensive dinners.

Each Family protects there own and each other. They make sure that people who are loyal to the Family business are taken care of. When professionals leave the Family to join the government (SEC) they pay them large departing bonuses (sometimes up to 3 times the difference between a government salary and their former salary in the firm). They provide them with a promise that they can come back and work for the Family when their government stint is up. These severance bonuses and promises for future employment amount to nothing less then bribery of a federal employee. Sometimes they hire the person back as a "consultant" to make sure that the arrangement is not well known or easily traceable. Since the partnerships are all private it's fairly easy to conceal these activities. The fact remains though - it occurs, and it occurs often.

The Honorable Carl Levin has noticed how corrupt these institutions have become. He told the Senate Finance Committee:

"Our investigation has found, sadly, what could be called a target-rich environment –numerous

respected accounting firms……… spending substantial resources, forming alliances, and developing the internal and external infrastructure necessary to aggressively design, market, and implement hundreds of complex tax shelters that U.S. taxpayers would otherwise be unable, unlikely, or unwilling to employ. And they are doing it in exchange for hundreds of millions of dollars in fees and other compensation, while denying the U.S. Treasury billions of dollars in revenues each year."

These firms are not just involved in corrupt tax shelters. They are actively promoting other services that can generate substantial revenues for their corrupt enterprises. They shake down their clients to ensure continued growth and prosperity for their illegitimate partnerships. When the House was considering the Sarbanes-Oxley Act, leaders from these firms publicly stated that the cost of compliance would be "insignificant." They claimed, in yet another organized message: "much of what was needed was already being performed by the auditors." They did not think that the impact to companies would be significant. Privately they were already scheming amongst themselves how they would be the ultimate beneficiaries of these rules by increasing in their "scope" by 25-35%. A number they uniformly communicated publicly once the legislation was passed.

When it was clear that they could no longer provide internal audit services for audit clients they cleverly made agreements among the Family members to trade clients. They agreed not to compete against each other and instead to acquire each other's business. In so doing they would keep prices up and prevent other smaller firms from competing for this business. Sometimes the deals were made on a local level so as not to appear to be in total violation of federal anti-trust laws. Sometimes they traded employees so the clients would have the same team serving them.

Then they put some of their top lieutenants together to figure out how to ensure that the requirements under section 404 would not be a one-time event but a rather "recurring revenue stream" for the profession. Their lieutenants met under the auspice of the Auditing Standards Board. They kept other (non-Family) members out of the discussions and worked feverishly to shape the agenda reading more stringent and challenging requirements into the Act. The worked together to make sure that their public comment letters to the SEC were closely aligned and sent a consistent message.

They devised means to ensure that this would represent a recurring revenue stream for them. Their long-term viability as a profession and growth were important considerations – but so to was the need to protect their "profession" from potential liability. They attempted to codify rules, by hastily passing new standards that maximized the definition of section 404 for their ultimate benefit. Many of the Auditing Standards Board's concepts have been incorporated into your proposed rules. Each was carefully devised to further enrich the organized racketeers of the Big Four accounting firms. The PCAOB should not ratify these rules without more careful and independent scrutiny.

Again and again the accounting Mafia has engaged in a scheme to shake down Corporate America. They charge huge premiums to 'protect' public companies and their board members. They actively collude with one another to ensure peace and unity in the "profession" and they operate by a silent code of rules that is not always publicly stated but clearly operative within the firms. Those loyal to the rules are indoctrinated into the partnership and rewarded great sums of money.

Establish rules that will end this legalized racket. Stop the abuse of Corporate America and free our executives from these modern day mobsters. This must be stopped. These rules should be repealed. If they cannot be repealed then at least remove the auditors from participating in this process. Establish rules that will not allow them to profit from their corrupt and illicit schemes.

If necessary hire an army of auditors for the PCAOB to periodically examine management's assessment of internal controls. Treat this like the IRS. Hire your own auditors to inspect management's assertions and to levy penalties when companies violate your rules. Don't model your rules based on the corrupt ideas put forth earlier this year by the illegitimate actions of the Accounting Standards Board and their Mafia-representatives.

Sincerely,

Zona Porter

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New York City, New York 10002
(212) 966-1277

Robert Posner
Retired Public Accountant
2404 Wyoming Ave NW
Washington, DC 20008

November 4th, 2003

Public Company Accounting Oversight Board
Attention: Office of the Secretary
1666 K Street, NW
Washington, DC 20006-2803

RE: Rulemaking Docket Matter No. 008

Dear Sir:

May the PCAOB REST IN PEACE!!!

Collaboration amongst the final four is at a record level. They are feverishly working together to try to figure out how to make sure your proposed rules lay the biggest possible golden egg. And the ideas are fabulous.

In your section "Testing & Evaluating Operating Effectiveness" the great minds of the big four have already met and figured out that "if internal audit works at the direction of the auditors" then they can rely upon internal audits work as part of the principal evidence to form their opinion. But, they won't call it internal audit work so it is not "technically a violation of the rules."

The final four make a great TEAM! They are working closely to find every loophole in your rules. They have found this way amongst themselves to get around this one rule – but their efforts are ongoing. They are a creative bunch.

No doubt they are already communicating amongst themselves on how to respond to the various questions you presented in your exposure draft. Their responses will be very similar. Many people outside of the public accounting industry will not dare to send in comments. The ridiculous charade will continue as the accounting professional continue to say one thing and do another.

The greedy partners will continue to lie, cheat and steal to get what they want. Anyone who gets in their way will be "professionally blackballed." They will continue the tyranny that gave us Enron, Tyco, HealthSouth and Adelphia.

I wish you well in your efforts to clean up this pandemonium.

Sincerely,

Robert Posner

Robert Posner

PPG Industries, Inc.
One PPG Place   Pittsburgh, Pennsylvania 15272

William H. Hernandez
Sr. Vice President, Finance

November 18, 2003

Office of the Secretary, PCAOB
1666 K Street, N.W.
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 008

Gentlemen:

This letter is furnished in response to The Public Company Accounting Oversight Board's proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* ("Proposed Standard"). PPG Industries, Inc. (PPG) is pleased to submit its comments on the Proposed Standard. PPG is a Fortune 500 company and a leading global producer of coatings, glass and chemical products. The company employs approximately 33,000 employees worldwide and maintains accounting records at over 200 sites around the world.

We have responded to Question #6 representing our overall view of the Proposed Standard. The remaining questions are then addressed offering our views as appropriate.

<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?***

   No. PPG Industries, Inc. believes that the scope presented in the Proposed Standard goes well beyond the letter of the law and the intent of Congress in passing the Sarbanes-Oxley Act into law. The Act clearly states that the public accounting firms should attest to the assessment of the internal control structure and procedures made by management, and we believe this requirement should not be expanded through interpretation into a requirement for a detailed audit of internal controls by the auditors.

   Further, the Proposed Standard places unnecessary restrictions on the extent to which the auditor can rely on management's and internal audit's work to assess the effectiveness of internal control. These restrictions will lead to duplicate efforts on the part of the company and the external auditor with the result that the auditor will essentially re-perform the audit work already performed by management. This serves no value to the shareholder and will lead to unnecessary, increased costs.

Questions regarding evaluation of management's assessment #6 (continued):

The example provided in the Proposed Standard of the auditor's opinion (Example A-1) to be issued as a result of performing this work is not consistent with the position taken by the Proposed Standard that an audit of controls be performed. The draft unqualified opinion states, "In our opinion, management's assessment that W Company maintained effective internal control over financial reporting as of December 31, 20X3, is fairly stated, in all material respects, based on [Identify criteria, . . .COSO for example]." This language refers to the assessment performed by management, not an audit of internal control performed by the auditor as required by the Proposed Standard. If the auditor is going to be required to perform an audit of controls, then the opinion should state that the audit work performed by the auditor supports their own assessment of the effectiveness of internal control.

The Proposed Standard should be revised to require the auditor only to assess management's evaluation of its internal control structure and procedures. However, if the Proposed Standard is not modified and an audit of a company's internal controls is required, then our responses to the remaining questions are offered for your consideration.

Other Questions

Questions regarding an integrated audit of the financial statements and internal control over financial reporting:

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?***

   No. The law specifically states that the auditor will attest to, and report on, the assessment of the effectiveness of the internal control structure and procedures made by management. Accordingly, the work performed by the auditor should support the attestation statement on the assessment made by management, not be an audit of the internal control environment of the company.

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?***

   No. As previously indicated, the auditor should attest to management's assessment of internal control, not perform an audit of the internal control environment. The attestation work performed by the public accounting firm should be an extension of the financial statement audit.

   If the final standard does require an audit of internal controls as presented in the proposed standard, then this should be treated as a separate engagement so that it can be managed separately. Public companies should then be able to enter into a competitive environment for selecting an auditor to complete the required work.

***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.***

   No. The Proposed Standard need not be so detailed as to address staffing qualifications for the auditor.

Questions regarding evaluation of management's assessment:

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

   Yes. Specific guidance is welcomed. The criteria should be clear to help avoid conflicts of opinion.

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?***

   Yes, we believe it is appropriate for the Proposed Standard to specify that inadequate documentation is an internal control deficiency, but the Proposed Standard should leave it to the auditor's judgment to asses the severity of the deficiency based on the facts and circumstances of each situation. A strong internal control environment could be in place and operating effectively even though the related documentation may not be complete. Inadequate documentation should be identified as a deficiency and be corrected, but it should not be presumed to be a significant deficiency or material weakness in internal control.

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?***

   If an audit of internal controls is required, then walkthroughs are an effective means of assessing the operational effectiveness of controls and should also be required.

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?***

    If an audit is required, then the auditor should be able to rely, in part, on walkthroughs performed and documented by the company's management or internal audit staff or others. Also see the response to #11 below.

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?

No, it is not appropriate because the level of work that would be performed by the auditor would be unnecessarily high. The auditor should be able to rely on the results of detailed work he performed in the recent past, along with the results of audit work performed by management, the internal auditor or others. A rotational approach to testing controls over significant locations and processes should be acceptable and made a part of the Proposed Standard.

The concepts of fair presentation, materiality, reasonableness and sampling are important to establishing the scope of an audit of financial statements conducted in accordance with generally accepted auditing standards. These concepts should be equally relevant to an audit of internal controls, which would suggest that the notion expressed in the Proposed Standard of having the auditor obtain evidence of controls for all relevant assertions for all accounts every year should be toned down. (Also see comments in response to question #6.)

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?

If an audit of internal control is required, then the auditor should be allowed to use the work of management, internal audit and others in a manner consistent with the guidance in generally accepted auditing standards covering an audit of financial statements. The auditor should be able to use the work of the Internal Audit function and rely on internal control documentation and testing performed at company locations.

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

No. There is no reason for the Proposed Standard to identify any categories of control related to which the auditor should not be able to use the results of testing performed by management and others. Of particular concern is the comment in the Proposed Standard that no reliance can be placed on the work of internal audit testing certain information technology general controls. In a company such as ours, these IT general controls are in place at a large number of locations around the world. It is impractical, unnecessary and costly to require the auditor to do all this testing ever year.

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?

No. The Proposed Standard does not give enough recognition to the work performed by the company's internal audit department. PPG, as with most public companies, maintains a professional Internal Audit staff. A risk evaluation is performed each year by Internal Audit management to plan appropriate audit coverage; and extensive work is performed by the audit staff to assess the internal control environment maintained throughout our operations.

The Proposed Standard should make it clear that the auditor can rely on the work of the internal auditors to reduce the auditor's work in auditing internal control to avoid unnecessary duplication of effort. This reliance should be patterned after the reliance an auditor can place on the work of internal audit to reduce the auditor's work in conducting an audit of the financial statements in accordance with generally accepted auditing standards.

15. Is the flexibility in determining the extent of re-performance of the work of others appropriate, or should the auditor be specifically required to re-perform a certain level of work (for example, re-perform tests of all significant accounts or re-perform every test performed by others that the auditor intends to use)?

Yes, we believe providing the auditor flexibility in this regard is appropriate and consistent with the view that professional judgment should be exercised by the auditor throughout the work performed.

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?

If an audit of controls is to be performed, then the Proposed Standard should contain guidance on the principal auditor consistent with that contained in generally accepted auditing standards for financial statement audits.

Questions regarding evaluating results:

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?

No. The Proposed Standard will not result in increased consistency because the definitions contain terms that are subject to professional judgment and interpretation based on the attendant facts and circumstances. This seems inevitable and does not suggest that more detailed definitions be developed. We do suggest that the definitions be rewritten using generally accepted, existing terms of art such as "remote," "reasonably possible" and "material'. The introduction of new terms like "more than inconsequential" will only add confusion and decrease consistency in the evaluation of deficiencies.

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 examples provide limited guidance because it is impossible to convey the complexity that exists in these real life situations. In each case the auditor's judgment must be used to evaluate the results of the work performed in the context of this complexity.

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

Yes. Each identified internal control deficiency should be evaluated as to severity.

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. We agree that all internal control deficiencies should be communicated to management in writing.

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

In principle, we agree that the identified weaknesses could be material. However, each case must be evaluated in light of the attendant facts and circumstances. The auditor's judgment must be used to reach a sound conclusion in each situation.

The Proposed Standard should not state specific conditions that prescribe a conclusion.

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?

No, the auditor should not be required to evaluate the effectiveness of the Audit Committee's oversight of the company's external financial reporting and internal control over financial reporting because it would put the auditor in the position of evaluating the group charged with the responsibility of hiring and overseeing the work of the auditor. Such a requirement would create an awkward situation for the auditor and one in which the auditor would at least appear to lack the independence necessary to make an objective evaluation of the Audit Committee's effectiveness in these areas.

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

No. The evaluation of the effectiveness of the audit committee's oversight should rest with the company's full Board of Directors. The Board of Directors should clearly establish objectives for the Audit Committee to achieve that are set forth in the Committee Charter and evaluate the Committee's performance against these objectives.

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. There can be situations where strong, effective internal controls exist throughout a company's operations although a weak Audit Committee is in place. Additionally, the evaluation of the Audit Committee is subjective at best. Requirements should be broader in nature and not specific.

<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?

Yes, assuming that the definition of a material weakness is made sufficiently clear in the Proposed Standard.

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

No, we believe the objective of the auditor's work is related to assessing the effectiveness of internal control over financial reporting in total. Allowing a qualified, "except for" conclusion would potentially create confusion in the mind of users of the financial statements concerning whether or not the controls over financial reporting are effective.

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. As indicated in our response to #6, we do not believe that the auditor should be auditing internal controls. The opinion presented by the auditor, whether it is a clean opinion or a non-standard opinion, should evaluate management's assessment of controls over financial reporting.

<u>Questions regarding auditor independence:</u>

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

Yes. Guidance on how internal control related non-audit services impact auditor independence would be appropriate.

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

Yes. All significant internal control related services and internal audit services should be prohibited because of their adverse impact on auditor independence.

Office of the Secretary, PCAOB
November 18, 2003

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. The procedures that the auditor must perform on a quarterly basis should be limited to inquiry of management about significant changes in the design or operation of internal control over financial reporting. Inquiry, in conjunction with the auditor's review of interim financial information performed during the quarter, should be sufficient to support the quarterly certification.

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

Yes.

NO RESPONSE

Question regarding an integrated audit of the financial statements and internal control over financial reporting.

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?

No comment.

Question regarding the costs and benefits of internal control:

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?

No comment.

If you have any questions or require additional information, please contact David B. Navikas, Vice President and Controller at (412) 434-3812.

Sincerely yours,

William N. [illegible]

cc: D. B. Navikas
J. S. McAwley
K. Edvardsson
J. Stephenson

PRICEWATERHOUSECOOPERS

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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, 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)

Dear Mr. Secretary:

PricewaterhouseCoopers LLP appreciates the opportunity to comment on the proposed auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* ("the proposed standard"), that has been prepared by the Public Company Accounting Oversight Board (the "Board").

We fully support the Board's efforts to further define and clarify management's and the auditor's respective responsibilities under Section 404 of the Sarbanes-Oxley Act (the "Act"). We believe the proposed standard strikes the proper balance between management's responsibility for the company's controls and their effectiveness, and the auditor's need to perform an independent audit while making appropriate use of the work performed by management and others to support management's assertion. It provides a logical framework and generally allows for the necessary exercise of the auditor's professional judgment. Specifically, we point to the following areas where we strongly support the proposed standard's conclusions:

- The proposed standard operationalizes the concept of one integrated audit process meeting two distinct objectives and resulting in two opinions—one on internal control over financial reporting and one on the financial statements. We believe this integration is key to meeting the public's expectations.

- The proposed standard properly recognizes that the auditor can make appropriate use of work done by management as part of its Section 404 assessment process. The standard's framework relating to the auditor's use of work performed by management and others generally provides a sound basis for auditors to make appropriate professional judgments, while still requiring that the auditor's own work must, at the end of the day, provide the "principal" basis for his or her opinion.

- We believe the Board's recognition of the importance of financial statement assertions as a key underpinning of an audit of internal control will significantly help auditors in performing effective audits of internal control. This will also emphasize the proper "linkage" between the audit of internal control and the additional procedures the auditor performs to complete the financial statement audit.

We have provided our answers to the Board's specific questions as well as more detailed comments in the attachment to this letter. However, we have several recommendations that we respectfully submit to the Board on how the goals of the proposed standard may be better achieved. These address the following:

- Reporting by the auditor
- Reasonable assurance
- Internal control deficiencies
- Evaluation of the audit committee's effectiveness
- Safeguarding of assets
- Multi-location testing considerations
- Walkthroughs
- Use of the work of others
- Extent of management's testing
- Evaluation of internal control for small and medium-sized companies
- Evaluation of management's assessment

<u>Reporting by the Auditor</u>

The proposed standard requires the auditor to issue an adverse opinion when one or more material weaknesses exist in the company's internal control over financial reporting. In our view, this requirement is too restrictive. We believe that the existence of one or more material weaknesses should not automatically result in an adverse opinion. In situations where a material weakness has an isolated impact on the overall effectiveness of internal control over financial reporting, we believe that the auditor should be allowed to apply professional judgment and issue a qualified or "except for" opinion. Examples of such situations might be a material weakness related to the preparation of timely account reconciliations at an individual business unit or location, or other instances where the impact is not so pervasive as to affect the overall integrity of the company's internal control. In these situations, a qualified or "except for" opinion provides more useful information to readers of the auditor's report as it allows the auditor to communicate a meaningful distinction between material weaknesses that have an isolated impact as opposed to a pervasive impact. This reporting alternative is particularly important considering the number of material weaknesses potentially being reported in the initial year. We believe auditors need flexibility to address situations where an adverse opinion resulting from an isolated material weakness could result in a disproportionately negative impression on users of a company's financial statements.

If the auditor is able to issue a qualified or "except for" opinion, management should also have that reporting alternative. The SEC's final rules implementing Section 404 state, "Management is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting." This does not appear to preclude management from making a qualified or "except for" assertion when there are one or more material weaknesses. Alternatively, if it is concluded that the existing 404 rules would not permit a qualified report by management, we believe the SEC should modify its Section 404 rules to allow management to make a qualified or "except for" assertion. This will provide the necessary symmetry between the rules governing management's assertion and those governing the auditor's opinion. We would be pleased to participate in discussions with staff of the PCAOB and the SEC to further explain our views in this regard.

Reasonable Assurance

We believe the following sentences in paragraph 18 of the proposed standard may create confusion as to the responsibilities of management and of the auditor with respect to the effectiveness of internal control over financial reporting:

"Users of the reports from management and the auditor are entitled to receive the same level of assurance from both management and the auditor. This means that users should expect reasonable assurance that internal control over financial reporting is effective."

"The auditor provides the same level of assurance, though not the same assurance, as management."

The responsibilities of management and the auditor are very different. As noted in Section 404 of the Act and in the SEC's final Section 404 rules, management is responsible for establishing and maintaining adequate internal controls and procedures for financial reporting and for evaluating the effectiveness of the company's internal control over financial reporting. The auditor is responsible for performing an audit and expressing an opinion on management's assessment of effectiveness or directly on the effectiveness of internal control over financial reporting. The auditor is not responsible for the effectiveness of the company's internal control over financial reporting.

Reasonable assurance for the auditor relates to performing an audit to evaluate whether effective internal control over financial reporting was maintained in all material respects. Reasonable assurance for management relates to management's assessment of internal control over financial reporting, not to management's responsibility for the effectiveness of the company's internal control over financial reporting.

We believe these sentences should be deleted from paragraph 18. In addition, we believe the following should be added to paragraph 18:

"The subsequent discovery of a material weakness in internal control existing at the date of the auditor's report on internal control over financial reporting is not, in and of itself, evidence of (a) failure to obtain reasonable assurance; (b) inadequate planning, performance, or judgment; (c) the absence of due professional care; or (d) a failure to comply with PCAOB standards. Since the auditor's opinion on internal control is based on the concept of obtaining reasonable assurance, the auditor is not an insurer and his or her report does not constitute a guarantee."

<u>Internal Control Deficiencies</u>

We believe the definitions of a significant deficiency and a material weakness included in the proposed standard provide greater clarity and permit more consistent application than the definitions in existing auditing literature. The new definitions better reflect a continuum from an internal control deficiency to a significant deficiency to a material weakness. However, we believe that by using the concept of "remote likelihood" in the standard's definition of significant deficiency, the Board has significantly, and in our view inappropriately, increased the number of internal control deficiencies that will be classified as significant deficiencies. As a result, auditors, management, and audit committees may spend excessive time reviewing deficiencies that are unlikely to ever rise to the level of a material weakness, while perhaps not giving enough attention to more significant items presenting greater risk. Also, the requirement that unresolved significant deficiencies be regarded as strong indicators of a material weakness, when combined with the proposed definition, could result in companies adopting controls that are not justified from a cost–benefit perspective.

We recommend that the Board reconsider its definition of significant deficiency in light of these potential consequences. We acknowledge the significant efforts of the Board and others in developing a workable definition of significant deficiency. We suggest that the Board engage interested parties—including the SEC, the preparer community, and auditors—in a coordinated effort to resolve this issue.

The examples of significant deficiencies and material weaknesses in Appendix D are helpful. We believe management and auditors would benefit from additional guidance and examples at the lower part of the continuum (i.e., examples of internal control deficiencies that would not be deemed to be significant deficiencies). Additional guidance and examples on distinguishing between testing exceptions that do not rise to the level of an internal control deficiency versus those that do also would be helpful.

<u>Evaluation of the Audit Committee's Effectiveness</u>

We agree that the auditor should evaluate the effectiveness of the audit committee's oversight, recognizing its role within the critically important control environment and monitoring components of internal control over financial reporting. Consistent with the framework established by the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) report, *Internal Control – Integrated Framework*, the auditor has a responsibility to evaluate the "participation by those who govern," including the audit committee, the board of directors, and management. However, we believe the evaluation of the audit committee's effectiveness should be in the context of the auditor's evaluation of the overall control environment. Singling out audit committee effectiveness for individual assessment overemphasizes one element of the control environment to the exclusion of others. As such, we believe that the auditor's responsibility to evaluate the effectiveness of those who govern, including the audit committee, does not extend beyond the auditor's evaluation of the company's control environment in the context of internal control over financial reporting. We also believe that it is the board of directors' role to determine the overall effectiveness of the audit committee.

We believe the auditor's evaluation of the effectiveness of those who govern—as part of the control environment—should be a qualitative assessment. We believe the list of factors in paragraph 57 for evaluating the effectiveness of the audit committee in the context of the overall control environment should be revised as they are not necessarily the most relevant for this purpose. For example, the amount of time that the audit committee devotes to control issues, and that audit committee members devote to committee activity, may not be directly relevant to the effectiveness of the audit committee. In addition, including the audit committee's compliance with the applicable listing standards adopted pursuant to Section 301 of the Act may be viewed as inappropriately extending the auditor's evaluation outside the scope of internal control over financial reporting and into areas of regulatory compliance, which are matters for legal determination and are outside the scope of the auditor's responsibility.

We recommend that the Board consider adding factors outlined on pages 26 and 27 of the COSO report as factors relevant to evaluating the effectiveness of those who govern, including the audit committee. Specifically, we believe factors such as the following should be considered for inclusion:

- Courage, willingness and ability to raise, scrutinize, and pursue difficult questions with both management and the auditor;
- Focus on areas of higher business or corporate governance risk;
- Understanding of critical accounting policies and highly subjective and judgmental accounting estimates; and
- Direct and independent interaction with key members of financial management, including the chief financial officer and the chief accounting officer.

However, by suggesting these factors, our intent is not to create a "checklist" approach for evaluating the effectiveness of those who govern. In this regard, we recommend that the standard clearly indicate that the auditor, while required to consider these factors, is not required to separately conclude on the audit committee's effectiveness with regard to each and every factor.

Safeguarding of Assets

We appreciate the Board's efforts in Appendix C of the proposed standard to clarify which controls are covered by the definition of safeguarding of assets. However, we do not believe the guidance in Appendix C is sufficient to answer the many questions that we see in practice regarding which controls relate to safeguarding of assets in a financial reporting context. For example, it is not clear what the Board's views are with respect to whether controls related to disaster recovery procedures, or controls designed to prevent unauthorized use of intellectual property (software, music, etc.), would be considered safeguarding of assets in a financial reporting context and therefore would require management and the auditor to evaluate their design and operating effectiveness. Such controls typically would have no direct impact on whether the historical financial statements are fairly stated. Accordingly, we do not believe that such controls should be included in the definition of safeguarding of assets for purposes of the proposed standard.

We believe Appendix C should be expanded to address these and other situations in order to avoid confusion as to what is intended by the definition of safeguarding of assets. This is particularly important because the effort to test many of the controls that might possibly be considered as relating to safeguarding of assets would be significant. Furthermore, depending on the final definition of safeguarding, such testing might require skill sets different from those normally encompassed by auditors' professional training and experience.

We also believe the existing definitions of internal control deficiencies, significant deficiencies, and material weaknesses may need to be revisited, once the scope of safeguarding of assets is better defined. These definitions are currently in the context of a potential "misstatement" in the financial statements. Deficiencies in areas such as those mentioned above, however, would not typically result in the risk of "misstatement" of the financial statements.

Multi-location Testing Considerations

We believe the guidance in Appendix B on multi-location testing considerations provides the auditor with a useful framework for exercising the considerable judgment needed to effectively plan an audit of internal control involving multiple locations or business units. We believe that auditors will require implementation guidance for situations where a company has many locations or business units (e.g., hundreds of retail stores or hotels) that are of approximately the same size, no one of which is relatively more financially significant than another. For example, guidance permitting the auditor to use some form of sampling in this type of situation may be appropriate.

Walkthroughs

We believe independent walkthroughs are an important part of the auditor's evaluation of the design effectiveness of controls and we support the PCAOB's requirement that the auditor perform walkthroughs of significant processes. We also believe that the objectives of walkthroughs set forth in paragraph 79 of the proposed standard are sufficient to make walkthroughs required procedures. Further, we believe the auditor should perform walkthroughs himself or herself rather than using walkthrough procedures performed by management, internal auditors, or others. To conclude on design effectiveness, it is essential for the auditor to develop his or her own point of view about risks and controls within significant processes. This is effectively accomplished by performing walkthroughs.

In our view, the requirement that the auditor "should trace *all* types of transactions and events, both recurring and unusual, from origination through the company's information systems until they are reflected in the company's financial reports" is excessive and inappropriately constrains the auditor's use of professional judgment. For example, a literal reading of this sentence could result in an auditor of a large multinational company performing hundreds of walkthroughs encompassing immaterial transactions and events at business units or locations that are immaterial individually and in the aggregate. We believe such a requirement is also inconsistent with the proposed standard's thrust—which we strongly support—of driving the auditor's efforts to those areas that the auditor judges to be important (e.g., significant accounts and disclosures, significant processes, important locations, etc.).

We do not believe the concept of significant processes that appears in paragraph 79 is consistent with that in paragraph 69. Paragraph 69 states that "the auditor should identify each significant process over each major class of transactions affecting significant accounts or groups of accounts." We recommend that this important point be incorporated in paragraph 79 to emphasize that the auditor's consideration of significant processes is solely in the context of major classes of transactions affecting significant accounts or groups of accounts and disclosures.

Use of the Work of Others

We believe that it is appropriate to consider the work of others in certain circumstances. We agree that the auditor's use of others' work must be subject to the auditor's overall conclusion, using professional judgment, that his or her own work provides the "principal" evidence for the auditor's opinion. We believe the proposed standard should clearly state that the auditor's judgment with regard to "principal evidence" is qualitative and not subject to quantitative measurements. For example, the auditor's determination of principal evidence might appropriately give greater weight to some areas of work performed by the auditor (e.g., the control environment) than to other areas (e.g., controls over routine processing of significant accounts and disclosures).

We agree generally with the three categories that the Board has outlined. However, we believe that the auditor should not be automatically precluded from using the results of testing performed by management and others of information technology general computer controls. Companies generally recognize the importance of information technology general computer controls and many (particularly in the financial services industry) have large and sophisticated internal audit functions that perform extensive testing of such controls. We believe the auditor's ability to obtain the principal evidence to support the opinion on internal control will not be adversely affected by permitting the auditor to use some of the testing performed by management. Accordingly, we recommend these controls be regarded as an area where auditors may make limited use of work performed by management and others, where appropriate.

We believe it would be highly unusual for the auditor's own work to provide the principal evidence required for the auditor's opinion without the auditor performing at least some independent testing of controls over routine processing of significant accounts and disclosures included in the third category.

Extent of Management's Testing

We believe the proposed standard provides useful guidance to the auditor in determining the nature, timing, and extent of testing to perform in evaluating design and operating effectiveness. However, similar guidance does not exist with respect to the required testing by management. As a result, many registrants do not have a consistent view of the extent of testing that is required for management to have sufficient evidence to provide a basis for its assertion. As a general rule, we believe that management's testing should be at a level that is at least equivalent to the level of testing generally expected of the auditor. We recommend that the PCAOB work with the SEC to provide management with appropriate guidance to ensure that management's testing is adequate and at least at a level reasonably consistent with that performed by the auditor.

We also believe that paragraph 126 of the proposed standard should be revised to add the following to the list of circumstances that are considered significant deficiencies and strong indicators of a material weakness: "The lack of sufficient evidence to support the management assertion regarding the operating effectiveness of internal control."

Evaluation of Internal Control for Small and Medium-Sized Companies

We believe that there should be no significant difference in the standard's requirements for small companies, other than to acknowledge the potential for a less formal internal control structure. While we agree that a small company will likely have less complex processes and, therefore, less complex controls, the same basic internal control tenets apply equally to all companies. The standard can provide only general guidance that auditors must then apply—using their professional judgment—to the facts and circumstances of a specific audit, only one of which is the company's size. While such facts and circumstances differ from company to company and affect the auditor's approach to gaining evidence, the auditor's need to obtain sufficient evidence to support his or her opinion is unchanged. Accordingly, we believe it is inappropriate for auditing standards to set forth different expectations for auditor performance based on the entity's size. Rather, standards should be written so that auditors can apply them in a flexible manner that appropriately recognizes each entity as unique.

Evaluation of Management's Assessment

We recognize that one of the issues faced by the Board in developing the proposed standard was whether the auditor's conclusion should relate to the effectiveness of a company's internal control over financial reporting or, alternatively, relate solely to the company's assessment process under Section 404. Both in the United States and globally, many organizations, companies, and auditors (including one of our territorial firms) have differing views on this subject. Some believe that Congress' intent in Section 404 was to have the auditor report on the effectiveness of internal control rather than on management's assessment process. Others believe—for various environmental, legal, and commercial reasons—that the auditor should report only on management's assessment process. While recognizing this honest divergence of opinions, we nevertheless strongly support the proposed standard's conclusion that, to best serve the public interest, the auditor's opinion must run directly to the effectiveness of internal control over financial reporting. We believe the auditor's independent audit of internal control effectiveness meets the intent of the Act.

To ensure clarity around this point and to eliminate confusion on the part of users, we believe the auditor should report in all cases directly on the effectiveness of the company's internal control over financial reporting rather than on management's assertion. Accordingly, the auditor's unqualified opinions in Report Examples A-1 and A-6 should run directly to the effectiveness of internal control. Consistent with these views, we agree with the proposed standard's requirement that the auditor report directly on effectiveness rather than on management's assertion when the auditor issues other than an unqualified opinion.

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We appreciate the opportunity to express our views and would be pleased to discuss our comments or answer any questions the staff may have. Please do not hesitate to contact Ray Bromark (973-236-7781), Gary Stauffer (973-236-5419), or Jim Lee (973-236-4478) regarding our submission.

Sincerely,

PricewaterhouseCoopers LLP

Attachment

This attachment includes:

- Comments on the impact of the proposed standard on other auditing standards,
- Responses to the specific questions presented in the proposed standard, and
- Other comments related to specific paragraphs in the proposed standard.

Comments on the Impact of the Proposed Standard on Other Auditing Standards

The proposed standard modifies guidance in the PCAOB's interim standards in several areas beyond AT Section 501. For example, paragraph 141 states that "the auditor's substantive procedures must include reconciling the financial statements to the accounting records." While we support this requirement, it and others, particularly in the section, "Effect of Tests of Controls on Substantive Procedures," would appear to go beyond existing auditing standards.

In such cases, we believe the PCAOB should identify and communicate how requirements in a proposed standard diverge from existing requirements and how issuance of the standard would affect existing standards.

As the PCAOB issues new standards or modifies its interim standards, we believe a formal process should be put in place to communicate in a clear and direct manner any changes to existing standards.

We also note the "Statement of Authority" preceding the proposed standard as it relates to the Board's proposed Rule 3101 regarding the use of certain terms in the Board's standards. We interpret the discussion as requiring adherence to the Board's proposed rule on use of certain terms, including its additional documentation requirements, in connection with the audit of internal control under this proposed standard. We believe this is inappropriate and suggest that its application to this standard await issuance of the final standard on use of terms.

Responses to Specific Questions Presented in the Proposed Standard

Questions regarding an integrated audit of the financial statements and internal control over financial reporting:

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?

Yes, we believe it is appropriate to refer to the auditor's attestation of management's assertion on the effectiveness of internal control over financial reporting as the audit of internal control 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?

Yes, the auditor should be prohibited from performing an audit of internal control over financial reporting, as required by Section 404 of the Act, without also performing an audit of the financial statements. In our view, only an integrated audit performed by the company's independent auditor can achieve the desired improvement in financial reporting effectively and efficiently.

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?

No. Requiring the auditor to perform work with regard to the financial statements comparable to that required to complete the financial statement audit is not an appropriate alternative to performing a financial statement audit.

Question regarding the costs and benefits of internal control:

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?

See our separate comments on the evaluation of internal control for small and medium-sized companies in our comment letter.

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.

We agree that competence and proper training of audit personnel are essential for the performance of effective audits. However, we believe the existing auditing standards (*PCAOB Interim Professional Standards*, AU Section 150) provide sufficient general guidance and the Board should not in this standard attempt to specify the level of competence and training of the audit personnel necessary to perform specific auditing procedures effectively. Any general consideration of auditor competence and training should be done as part of the Board's review of its interim standards. While such review could encompass this issue, we believe that auditors—at an engagement level—require flexibility in determining the appropriate staff to perform different aspects of the audit work.

Questions regarding evaluation of management's assessment:

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?

See our separate comments on evaluation of management's assessment in our comment letter.

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

Yes, it is appropriate for the Board to provide criteria that auditors should use to evaluate the adequacy of management's documentation. Comparable to the auditor's documentation, management's documentation is the principal record of the assessment procedures applied, evidence obtained, and conclusions reached by management as to the effectiveness of the company's internal control. Criteria for evaluating the adequacy of management's documentation provide a useful frame of reference, benefiting both auditors and management.

We believe the Board needs to clarify paragraph B-3 of the proposed standard with regard to documentation of controls where the company has multiple locations or business units. For example, does the guidance in paragraph B-3 mean that management would not be required to have controls documented at locations or business units that are not able to create, either individually or in the aggregate, a material misstatement? We believe management should have at least a minimum level of documentation of controls at these locations consistent with the requirement that registrants must maintain adequate books and records.

We believe more guidance is needed also in the area of documentation of locations or business units that individually are insignificant but when aggregated could result in a material misstatement. For these locations, we believe management should be required to document controls over relevant assertions relating to significant accounts at the consolidated financial statement level. Without appropriate documentation, we do not believe management could demonstrate adequate company-level controls since documentation of controls is a foundation of company-level controls.

Further, as part of providing criteria that auditors should use to evaluate the adequacy of management's documentation, we believe that the Board and the SEC should provide guidance on management's retention of documentation as well as the auditor's retention of management's documentation of the entity's systems and controls.

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?

It is appropriate to state that inadequate documentation is an internal control deficiency, the severity of which the auditor should evaluate. We do not believe that inadequate documentation would automatically rise to the level of a significant deficiency or material weakness in internal control.

We believe the severity of the inadequate documentation should be evaluated by the auditor and, based on his or her professional judgment, appropriately categorized as an internal control deficiency, a significant deficiency, or a material weakness. Every situation will be different and will require its own evaluation and conclusion.

We recommend that the last sentence in paragraph 46 be revised to more clearly communicate what we believe to be the intended meaning—that the monitoring component of internal control cannot be demonstrated in the absence of sufficient evidence to support management's assertion. Alternatively, if the Board believes that there are ways in which management can demonstrate the monitoring component in the absence of documentation of controls, we believe there needs to be clarification around this statement and examples of how management would do this.

<u>Questions regarding obtaining an understanding of internal control over financial reporting:</u>

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

See separate discussion of walkthroughs in our comment letter.

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 separate discussion of walkthroughs in our comment letter.

<u>Question regarding testing operating effectiveness:</u>

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?

We believe that it is appropriate to require the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for significant accounts and disclosures every year. Reliance on prior year work is inappropriate. However, we believe the source of the evidence (direct or indirect) and the nature, timing, and extent can vary from year to year.

In the case of automated application controls, where the auditor believes that controls are unchanged, evidence of the lack of change and the continued operating effectiveness can come from annual walkthroughs of major transactions within significant processes, along with testing of IT general computer controls annually.

We believe that paragraph 101 of the proposed standard should be revised to clarify that each year's audit of internal control must stand on its own and encompass not just all internal control components but all relevant assertions for all significant accounts and disclosures.

<u>Questions regarding using the work of management and others:</u>

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

The auditor should be permitted—but not required—to use the work of management and others. The auditor should evaluate the competence and objectivity of those performing the work and apply professional judgment to determine how the work of management and others affects the nature, timing, and extent of the auditor's own procedures, underpinned by the requirement that the auditor's opinion be based principally on evidence that the auditor has independently obtained.

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

See separate discussion on use of the work of others in our comment letter.

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?

We believe the proposed standard gives appropriate recognition to the work of internal auditors. As outlined in the proposed standard, the auditor should assess internal audit's objectivity and competence using the same criteria as for the objectivity and competence of management and others when determining the level of use of their work.

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)?

We believe that the judgment contemplated in the proposed standard with regard to the level of reperformance when using the work of others is appropriate.

16. Is the requirement for the auditor to obtain the principal 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?

Yes. Recognizing that this determination must necessarily be based on the auditor's qualitative judgments and not quantitative measures, we believe that the standard of principal evidence is the appropriate benchmark for the amount of work required to be performed by the auditor.

<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?

See our separate comments on internal control deficiencies in our comment letter.

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?

See our separate comments on internal control deficiencies in our comment letter.

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

Yes. We believe that it is necessary for the auditor to evaluate the significance of all identified internal control deficiencies. Without performing an evaluation, auditors would have no basis for determining whether an item was of "inconsequential" magnitude or "remote likelihood," or alternatively rose to the level of a significant deficiency or material weakness. We also believe that it is essential for management to develop a similar process to evaluate all identified internal control deficiencies. In our view, management and auditors would benefit from additional guidance and examples, as discussed in our comment letter.

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. We believe it is appropriate for the auditor to communicate to management all internal control deficiencies he or she has identified. Documentation and communication of this identification and evaluation process are necessary and will contribute to consistency on engagements and also provide a formal mechanism for management to address and respond to identified deficiencies. However, we believe the requirement in paragraph 191 of the proposed standard for the auditor's communication to also include or refer to deficiencies identified by internal audit and others is inappropriate. We believe it is management's responsibility to ensure they receive such communications.

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

We believe the guidance in paragraph 126 regarding circumstances that are strong indicators of a material weakness in internal control over financial reporting is useful to both management and the auditor. We do, however, have several points on the specific circumstances cited:

- We believe that the absence of sufficient evidence to support the responsible party's evaluation of the operating effectiveness of internal control is a strong indicator of a material weakness and should be added to the list in paragraph 126 and deleted from paragraph 125.

- Consistent with our views expressed in our comment letter, we believe that an ineffective control environment should be added to paragraph 126.

- As stated in the Board's interim standard, AU Section 317, auditors are responsible to consider laws and regulations that have a *direct and material* effect on the determination of financial statement amounts. While we agree an ineffective regulatory compliance function may result in a direct and material misstatement in the financial statements (e.g., noncompliance with tax laws affecting the determination of financial statement amounts) and therefore be encompassed within internal control over financial reporting, there are many aspects of regulatory compliance that by themselves may be ineffective but would not affect the financial statements, or would affect them only indirectly (e.g., contingent liabilities for violations of environmental laws and regulations). Accordingly, we believe it is inappropriate to specify the entire regulatory compliance function. This gives the erroneous impression that regulatory compliance (encompassing laws and regulations related to areas such as securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment, price fixing, and antitrust) is entirely within the definition of internal control over financial reporting and within the auditor's expertise to evaluate. We believe the fifth bullet in paragraph 126 should be deleted or, at a minimum, modified to make it clear that it is limited to situations where the ineffective regulatory function relates solely to those aspects where related violations of laws and regulations could have a direct and material effect on the financial statements.

- While we agree fraud on the part of senior management is a serious issue, we do not believe it is the responsibility of the auditor to identify fraud of any magnitude. We also do not believe that fraud of any magnitude would necessarily constitute a significant deficiency or a material weakness, particularly in situations where the company's controls uncovered the issue. Further, we do not believe that the auditor should be required to identify issues that occur outside the company's environment, such as an individual's filing a false tax return.

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?

See our separate comments on the evaluation of the effectiveness of the audit committee in our comment letter.

We note that the proposed standard would require the auditor to evaluate factors related to the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting, including, among other factors, the independence of the audit committee members from management. Paragraph 58 of the proposed standard states that as part of evaluating the independence of audit committee members, the auditor should evaluate how audit committee members are nominated and selected and whether they act independently from management. The SEC release implementing Section 301 of the Act contains certain exemptions with respect to independence requirements for foreign private issuers. Accordingly, to be consistent with the provisions of the SEC rules implementing Section 301 of the Act, we believe that the exemptions granted to foreign private issuers should be considered in the auditor's evaluation of the independence of committee members.

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

See our separate comments on the evaluation of the effectiveness of the audit committee in our comment letter.

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?

We believe the existence of a specific material weakness should not automatically result in the auditor's resignation. The existence of an ineffective audit committee, coupled with a mandate for auditor resignation, clearly would not be in the public's interest. Rather, auditors should be able to make this decision, as they do now, based on all the facts and circumstances of the engagement.

<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?

See our separate comments on reporting by the auditor in our comment letter.

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

See our separate comments on reporting by the auditor in our comment letter.

27. Do you agree with the position that when the auditor issues a nonstandard 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?

See our separate comments on reporting by the auditor in our comment letter.

<u>Questions regarding auditor independence:</u>

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

We believe that adequate guidance is contained within the independence rules issued by the SEC.

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

We believe the existing independence requirements that were adopted by the SEC in February 2003 are appropriate and should be given sufficient time to operate.

<u>Questions regarding auditor's responsibilities with regard to management's certifications:</u>

30. Are the auditor's differing levels of responsibility as they relate to management's quarterly certifications versus the annual (fourth quarter) certification, appropriate?

We believe it is appropriate to have a differing level of responsibility as it relates to the fourth quarter certification.

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

We agree that inquiry coupled with observation are the appropriate procedures to perform for internal control over financial reporting for quarterly disclosures. We also believe that the Board should clarify that these procedures are not an adequate basis for reporting and that it was not envisioned that the auditor would be permitted to report on internal control over financial reporting on a quarterly basis.

We are concerned that paragraphs 8 and 9 of the proposed standard may imply that the auditor is required to identify deficiencies that could result in a misstatement in interim financial statements. We do not believe that the auditor should be required to plan his or her audit of internal control at a materiality level of the interim financial statements.
To conform the wording to that relating to management in the SEC's final 404 rule, we recommend that the existing language in the second bullet of paragraph 186 be changed to: "Determine, through a combination of observation and inquiry, whether any change in internal control over financial reporting has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting."

We believe the auditor evaluation responsibilities described in paragraphs 185 through 189 should not be required until the first quarter after the company's issuance of its first annual 404 report.

Other Comments Relating to Specific Paragraphs in the Proposed Standard

Paragraph 21 – In our view, this paragraph intermingles—and is likely to cause confusion with regard to—several important concepts: planning materiality vs. materiality in evaluating internal control deficiencies; materiality at a financial statement level vs. materiality at an account-balance level; and significant deficiencies vs. material weaknesses. Specifically:

- We believe the concept of materiality at an account-balance level is more relevant to planning materiality than to an evaluation of deficiencies, as the paragraph seems to imply. The auditor must plan the audit to obtain reasonable assurance that deficiencies that, individually or in the aggregate, would represent material weaknesses are identified. In doing so, the auditor must appropriately plan his or her other work at an account-balance level.

- The auditor evaluates deficiencies at the overall financial statement level, not at the account-balance level, as the paragraph seems to imply. Deficiencies at an overall financial statement level, e.g., deficiencies in a particular facet of the control environment, may be significant deficiencies or rise to the level of material weaknesses. Similarly, an internal control deficiency present at an account-balance level may be a significant deficiency or rise to a material weakness, again when evaluated at the financial statement level, not at the account-balance level, as the proposed standard presently implies.

We recommend that the Board re-examine and clarify the important concepts in this paragraph.

Paragraph 24 – We recommend that the first bullet be changed from "controls restraining the inappropriate use of company assets" to "controls restraining misappropriation of assets that could result in a material misstatement." This would tie the statement to the definitions and guidance in the existing standard on fraud as well as eliminate overly subjective judgments as to what might be considered "inappropriate."

Paragraph 41 – We believe the second bullet should address magnitude as well as likelihood.

Paragraph 78 – We recommend including additional guidance on the extent to which redundant controls need to be tested, along with specific examples of those controls that the auditor would be expected to test because "redundancy is itself a control objective, as in the case of certain computer controls."

Paragraph 112 – The last sentence states, "A conclusion that an identified exception does not represent an internal control deficiency is appropriate only if evidence beyond what the auditor had initially planned and beyond inquiry supports that conclusion." We believe that auditors would benefit from additional guidance. We agree that the auditor should obtain evidence regarding the underlying reason for and implications of any exception. However, we do not believe that the existence of one or more exceptions would necessarily require the auditor to increase the number of items tested if the number of exceptions was within an acceptable range that would allow the auditor to conclude that the control was operating effectively.

Paragraph 114 – In our view, this paragraph is also overly prescriptive in requiring that the auditor review all reports issued during the year by internal audit. This inappropriately restricts the auditor's use of professional judgment and will potentially lead to inefficiencies. For example, in a multilocation audit this would require auditors to review internal audit reports for numerous locations that—even when aggregated—could not be material. Also, companies should have controls in place to assess all deficiencies identified by internal auditors, and the auditor should be allowed to make appropriate use of such work, without being required to directly review all reports.

Paragraph 128 – As presently written, item d. requires management in its representation letter to state only that it has disclosed to the auditor "all significant deficiencies … that it believes to be material weaknesses." We believe management's communication responsibilities to the auditor should be comparable to those of the auditor to management. Accordingly, in addition to material weaknesses, management's required communications should encompass inconsequential deficiencies as well as significant deficiencies that, in management's judgment, do not rise to the level of material weaknesses.

November 21, 2003

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

Subject: PCAOB Rulemaking Docket No. 008
Proposed Auditing Standard – An Audit if Internal Control Over Financial Reporting

Members and Staff of the Public Company Accounting Oversight Board:

Thank you for the opportunity to comment on the proposed auditing standard on an audit of internal control over financial reporting performed in conjunction with an audit of financial statements. Overall we support the proposed standard. However, there are certain areas of the proposal we do not agree with and are submitting the following comments.

Limitation on the Use of the Work of Management and Others (Questions 10, 12-16)
There is little doubt that the costs of being a public company have increased significantly as a result of the frauds committed by a few companies and the resulting requirements imposed by the Sarbanes-Oxley Act of 2002 (the Act). We support the objectives of the Act and believe swift implementation of its various provisions is needed. We understand that the public's trust of management and independent auditors has been impaired, and such trust needs to be restored as quickly as possible. However, we believe the proposed limitation on the use of the work of management and internal audit is an unnecessary restriction that only serves to increase the costs of the audit. There will always be a substantial degree of judgment involved in preparing financial statements, assessing internal controls, and auditing such financial statements and internal controls. There is no way to avoid it other than to require 100% documentation and verification of all areas, which of course is unrealistic. We don't believe that selecting certain categories of controls that the independent auditor cannot use the work of others or to require specific walkthrough procedures for every process eliminates the need for judgment enough to justify the additional costs that would result.

Furthermore, Statement of Auditing Standards No. 65 (SAS 65) provides a basis for the auditor to determine when it is appropriate to rely on the work of internal audit and its concepts could also be applied in all areas of an audit of internal controls over financial reporting. SAS 65 has been in used in practice since 1991 and utilizes a risk-based approach to determine where it may be appropriate to rely on the work of internal audit and provides adequate guidance in this regard. While we can appreciate the hesitancy to allow for the utilization of the work of others in certain categories of controls, ultimately the evaluation of the work rests with the independent auditor. At a minimum, it seems appropriate for the independent auditor to rely on the work of an internal audit group in circumstances identified by the concepts of SAS 65. Allowing for use of the work of others in all areas of the internal control audit is a matter of efficiency and does not compromise the auditor attestation.

Adequacy of Management's Documentation (Question 7)
I understand and agree that the independent auditor needs to evaluate the adequacy of management's documentation in order to determine if management's assessment of internal controls over financial reporting was adequate. Many public companies are struggling with how much documentation is appropriate without becoming overly procedural and detailed. While we believe the standard provides appropriate guidance as to the consequences of inadequate documentation, we do not believe that the proposed standard adequately defines what is adequate and what is not. The consequences of inadequate documentation are so severe that the standard needs to provide very specific guidance to the auditor, and management, regarding the criteria to evaluate management's documentation. As written, the standard is very general and leaves much to the discretion of the independent auditors. Both management and auditors would greatly benefit from much more specific requirements regarding the sufficiency of documentation.

Again, we appreciate the opportunity to comment on the proposed standard. Thank you for considering our views. We would be glad to discuss these comments with you at your convenience.

Respectfully submitted,

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November 21, 2003

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Dear Mr. Secretary:

Re: PCAOB Rulemaking Docket Matter No. 008: Comments on Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

We respectfully submit our comments on the PCAOB's proposed standard on auditing internal control over financial reporting as part of an integrated audit. We have focused our comments on several, rather than all, of the PCAOB's questions below. We have numbered the questions according to the numbering scheme in the PCAOB's Release No. 2003-017 dated October 7, 2003.

10. Is it appropriate to require that the auditor perform a walkthrough himself or herself, rather than allowing the auditor to use walkthrough procedures performed by management, internal auditors, or others?

No. The auditor should be allowed to rely on competent and objective internal auditors (or other similar parties, such as a separate process or risk control group which does not have the responsibility for executing processes) in the performance of walkthroughs that are effectively documented, provided the auditor is able to satisfy himself or herself about the adequacy of this work through appropriate procedures.

If the PCAOB (hereinafter sometimes referred to as the "Board") does not concur with this view, then at a minimum the Board should clarify that, for purposes of performing a walkthrough, the auditor may rely on documentation (process maps, process narratives, etc.) prepared by the audit client. As a practical matter, the Section 404 compliance teams for many companies, as well as their internal auditors, are documenting walkthroughs as a basis for understanding internal control over financial reporting, including the process flow of transactions, the completeness of the design of controls within the processes and whether and how the controls really operate – the same objective as that of the external auditor. The external auditor should be able to rely on this documentation and use it when reviewing documents that are used in, and that result from, the application of the controls, and comparing supporting documents to the accounting records.

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

Generally, if the intent is to prescribe the nature and extent of auditor reliance, the three categories of controls provide an effective framework for articulating the extent of reliance (however, please see our comment on Question 14 regarding the commingling of internal audit into the definition of "others"). Within the "no reliance" category, however, the proposed standard includes such pervasive controls as "certain information technology general controls on which the operating effectiveness of other controls depend." We do not understand the rationale for this conclusion. We recommend that the Board clarify the nature of these "certain" controls and reconsider specifically which controls should be included in the "no reliance" category.

General IT processes are expansive in scope. They include, among other things: security administration, application change controls and data management and disaster recovery. We recommend the Board clarify the nature of the "certain information technology general controls" to which it refers in the proposed standard.

We suggest the Board also reconsider its position on general IT controls and include general IT controls in the second category of reliance, i.e., "controls for which there may be limited reliance." IT general controls are not "soft controls" subject to a significant amount of judgment in evaluation. While the Board is correct that they are pervasive in scope and can impact the effectiveness of other controls, general IT controls are effected through processes that function just like revenue, purchasing and other routine processes, and are subject to similar kinds of testing. For example, general IT controls ordinarily address the critical IT processes within each entity or for each key location that supports significant financial applications. In certain circumstances, the same general controls area must be reviewed more than once. If there are multiple processes impacting each priority financial reporting area that are not subject to similar policies, process activities and control procedures, these multiple processes may need to be separately reviewed. Many of these control areas consist of controls that are subject to reperformance by the external auditor. Thus we recommend that general IT controls be included in the second category of reliance.

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?

We do not believe that the proposed standard gives sufficient recognition to or enough emphasis on the work of internal auditors in applying the Board's proposed "three categories" construct. The Board should consider differentiating between the work of competent and objective internal auditors (or other similar parties) and the work of process or control owners who execute the processes and document management's assertion in the internal control report. As companies experiment with ways to structure their organizations

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to accomplish the Sarbanes-Oxley certification objectives, the Board's standards should be flexible enough to recognize that internal audit or similar parties, such as a separate process or risk control group, may be capable of providing a reliable basis for conclusions.

We recommend that the Board separately evaluate the three categories of reliance against two groups – (i) management and others, excluding internal audit (or other similar parties), and (ii) internal audit (or other similar parties). We believe that there are some areas within the three categories that might be viewed differently between these two groups. For example, if competent and objective internal auditors (or other similar parties) test the general IT controls, as discussed above under Question 13, the auditor should be able to place at least limited reliance on that work.

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?

No. This requirement has the potential to severely limit the extent of the auditor's reliance, regardless of the Board's guidance with respect to the "three categories", the effectiveness of the internal control structure and the nature, extent and timing of management's work and documentation supporting the conclusion expressed in the internal control report. Because the "three categories" already place a limit on the extent of reliance, the Board should evaluate whether this statement is really needed. If the PCAOB concludes the statement should be retained in the final standard, the Board should clarify how the statement is applied in view of the guidance it already provides with respect to the "three categories".

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

In the list of circumstances that should be regarded as at least a significant deficiency and as a strong indicator of a material weakness, the proposed standard included a reference to "an ineffective regulatory compliance function" in highly regulated industries. We agree that this type of deficiency can be troublesome. However, does the reference to this type of deficiency suggest that documentary evidence is required to support an assertion that such a deficiency does not exist? We cannot find any guidance in the proposed standard where this question is addressed. Because this is a potentially broad audit area, we recommend that the Board clarify the nature, extent and timing of work needed to address it.

If the standard is intended to require additional work, the question arises as to whether such a requirement extends beyond the coverage intended by the SEC's final rule on Section 404. Note that in its final rule, the SEC states "our definition [of internal control over financial reporting] does not encompass the elements of the COSO Report definition that relate to effectiveness and efficiency of a company's operations and a company's compliance with applicable laws and regulations, with the exception of

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compliance with the applicable laws and regulations directly related to the preparation of financial statements, such as the Commission's financial reporting requirements."

We suggest that the Board clarify its intentions on this point.

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?

We believe that the board of directors is ultimately responsible for evaluating audit committee effectiveness using the criteria set forth in the proposed standard. The external auditor, who is hired by the audit committee, is not in the best position to make the call as to the committee's effectiveness and would have a difficult (if not impossible) challenge to do so while retaining a position of independence both in fact and appearance. We agree that an ineffective audit committee adversely affects an evaluation of internal control over financial reporting. However, under Section 301 of The Sarbanes-Oxley Act, an audit committee has direct responsibility to hire, fire, compensate and evaluate the auditors. In addition, the auditor is not always present during committee meetings and deliberations.

If the PCAOB decides to retain this requirement, the question arises as to how auditors are required to satisfy themselves that a company's audit committee is providing effective oversight of external financial reporting and internal control over financial reporting? Are the criteria provided by the proposed standard of certain legal and regulatory requirements and certain qualitative factors adequate? What procedures will the auditor need to perform? What are the implications of those procedures in terms of requiring auditor access to audit committee deliberations and interfaces with management and others in situations in which the auditor is not always present? What is an appropriate level of involvement and interaction by the Committee? How does the auditor determine whether audit committee members "act independently from management?" Clarity is needed for these questions not only for auditors but also for audit committees and management so they will better understand what to expect from the audit process.

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 recommend that the Board provide specific guidance on independence in the context of this proposed standard. In our experience, there continues to be divergent views between public companies and between and within the accounting firms themselves as to the nature and scope of internal control-related services a company's external auditors can provide. For example, we see different approaches being taken in similar circumstances where, on the one hand, companies hire their external auditors to document their internal controls and, on the other hand, companies decide not to engage their auditors to do this work on the basis that such action could present independence in appearance issues. We also see instances where some external audit

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firms have taken similar public positions to not engage in this work for the same reasons. It is therefore an issue where reasonable men and women can differ. While specificity exists regarding the prohibited services associated with financial statement audits, no such list has been addressed with respect to reporting on internal controls since the issuance of the new Section 404 reporting requirement. Some degree of granularity, similar to the list of ten prohibited non-audit services in conjunction with the audit of financial statements, would enable boards and audit committees to better comply and avoid public misconceptions regarding auditor independence.

We have attached to this letter an excerpt from our frequently asked questions publication, released in August, which includes a question on the internal controls documentation matter. We also point out to the Board that there are other issues besides documentation that the Board should provide guidance on with respect to independence and internal control-related non-audit services in the context of the proposed standard.

We appreciate the opportunity to submit our comments. We hope they are helpful to the staff. If the staff would like to discuss any of the points made in this letter, please contact Jim DeLoach at (713) 314-4981.

Very truly yours,

PROTIVITI INC.

James DeLoach

By: James W. DeLoach, Jr.
Managing Director

ATTACHMENT

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ATTACHMENT

Excerpt from *Guide to the Sarbanes-Oxley Act: Internal Control Reporting Requirements* -- QUESTION 150

Can the company engage the independent public accountant to create original documentation of its internal control over financial reporting without impairing independence?

The safe answer in today's environment is probably not. According to Rule 2.01 of Regulation S-X of the SEC, the external auditor must be independent both in fact and in appearance. While the standards have not been promulgated by which the external auditor will be required to attest, significant involvement in the documentation of a company's internal control structure, followed by an attestation process in which the same documentation is reviewed, would be tantamount to keeping the books and auditing the books. The SEC's position is that the auditor cannot perform in the role of management or audit his or her own work.

During its open meeting in May 2003, the SEC made statements to the effect that the documentation of controls and the evaluation of their effectiveness is indeed a management function. Therefore, if the auditor has been asked to perform that role instead of or on behalf of management that would involve the auditor taking on a management role. Thus the SEC staff pointed out that companies and their auditors need to be mindful of the independence requirements and determine how involved the auditor needs to be to understand adequately the controls and what management has done without having to actually "step into a management role."

The final rules released on June 6, 2003, do not reconcile clearly to the discussion during the open meeting in May. Specifically, in the open meeting, an absolute restriction was articulated as a "red light" to prohibit the independent accountant from documenting internal control over financial reporting for audit clients. The final rules, however, do not prohibit this practice but instead place limits around this activity and remind issuers and their auditors to adhere to the independence restrictions.

This development is not a surprise. The SEC has a long-standing practice of allowing issuers to formulate their own policies with respect to compliance matters. Subsequent to the open meeting, the SEC staff pointed out to us that nothing said in the open meeting or included in the final release on Section 404 is intended to change the independence release or rules, or the appropriate interpretation of those rules. When formulating company policies in this regard, management and audit committees must take into account the SEC's oral comments in the open meeting as well as its written rules. Thus the burden is on management and the audit committee to evaluate the desirability of engaging the independent accountant in documenting internal control over financial reporting on behalf of management. In effect, the final rules constitute a "yellow light" of caution signaling to companies that it would be wise to monitor further SEC and

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PCAOB developments for additional clarification in what could very well be an evolving area.

In the final rules, the SEC states it understands the need for management and the company's independent auditors to coordinate their respective activities relating to documenting and testing internal control over financial reporting. In stating that understanding, the SEC also issued two reminders to companies and their auditors:

- First, the Commission's rules on auditor independence prohibit an auditor from providing certain nonaudit services to an audit client.
- Second, management cannot delegate its responsibility to assess its internal control over financial reporting to the auditor.

The SEC also made two other points on independence:

- If the auditor is engaged to assist management in documenting internal controls, management must be actively involved in the process.
- Management's acceptance of responsibility for the documentation and testing performed by the auditor does not satisfy the auditor independence rules.

The above views expressed by the SEC raises several points.

- First, documentation of internal control over financial reporting by the independent accountant is implied to constitute a nonaudit service.
- Second, if the auditor performs documentation and testing of internal controls, management cannot simply accept responsibility for that work. This would be tantamount to management accepting responsibility for the results of bookkeeping or other services provided by the auditor related to the company's significant accounting records or financial reporting areas. Management must be actively involved in the documentation process.
- Third, the auditor must exercise care to ensure that he or she does not end up auditing his or her own work or provide a service acting in a management capacity.
- Finally, while there is some ambiguity in the final rules that didn't exist during the SEC's open meeting in May 2003, it appears the overriding message is for management, and the audit committee, to proceed with care when engaging independent accountants to document internal control over financial reporting.

One practical approach to addressing the ambiguity of this issue is to focus on the magnitude of the documentation required to bring a company into compliance. This approach, which has been embraced by one major accounting firm, would prescribe that any situation in which "significant" documentation was necessary should avoid engagement of the external auditor other than in an advisory role. On the other hand, those environments in which minimal additional documentation was necessary might

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utilize the external auditor to help management identify and finalize the Section 404 documentation.

Sarbanes-Oxley requires management to establish and maintain controls and procedures to ensure all material information is presented to the public in accordance with the SEC's rules and forms, i.e., management is required to design the internal control structure. The documentation issue represents a minefield for boards and management teams because it will forever remain difficult to delineate the difference between documenting the internal control structure and designing the internal control structure. Documenting an internal control structure is similar to "blazing a trail." It requires a decision-tree type approach in which someone must decide each path to achieve an appropriate control structure. The selection of the primary path is a function of the risks that management perceives the company faces. Subsequent decision points will revolve around questions such as:

- What is the proper combination of preventive controls or detective controls?
- Do transaction volume and velocity permit manual controls or must computerized system controls be utilized?
- Within a process, how much segregation of duties is required?
- Are there pervasive controls affecting multiple processes and, if so, what is their impact?
- What is the impact of a centralized versus decentralized organization?

Each of these and other decisions require significant professional judgment. They represent trail markers about which management must make the ultimate determination. If the independent public accountant is asked to blaze and mark the trail and subsequently also determine if the markings are correct, then management, the board and the auditor could be exposed to allegations that independence was impaired. While independence in fact may have been preserved, the appearance of independence would be difficult if not impossible to explain in the public arena. If explanations are subsequently required, the accounting firm could be placed in the position of an advocate for management, a position the SEC rules do not permit. Given today's hypersensitive environment, this issue does not appear to be one in which it is in anyone's interest to test.

November 21, 2003

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

RE: **PCAOB Rulemaking Docket Matter No. 008**
Proposed Auditing Standards – An Audit of Internal Controls Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

Members and Staff of the Public Company Accounting Oversight Board:

Thank you for the opportunity to comment on the proposed standards on an audit of internal controls over financial reporting performed in conjunction with an audit of financial statements. PSEG is a $21 billion energy and energy services company with three major subsidiaries: PSE&G, a regulated electric and gas distribution business, PSEG Power, a major US power producer and PSEG Energy Holdings, the parent of PSEG's other unregulated businesses including: PSEG Global a major international developer and operator of power generation and distribution systems throughout the world, and PSEG Resources, which invests in energy-related financial transactions. As a member company of the Edison Electric Institute (EEI) we support the comments of the EEI but offer the attached request for clarification. We believe such clarification would make the standards more effective by reducing potential misinterpretation.

I would be please to discuss my comments with the Board or its staff at your convenience.

Sincerely,

Kathy A. Fudali
PSEG Services Corporation
Director, Internal Controls

PSEG Service Corporation
Request for Clarification
Re: PCAOB Release No. 2003-17

Items	Page #	Std #	Clarification Request
1	P9 A-33	N/A 88	Please provide clarification on whether management is required to document the necessary qualifications of the people performing the control for the control to function effectively.
2	P9	N/A	Please provide clarification on what is meant by needing to document "the process that management used to assess the effectiveness of the internal control over financial reporting."
3	P11/ P23	N/A	In the case of companies that file consolidated 10Qs and 10Ks and have a fiscal year-end after June 15, 2004, is it the intent of the PCAOB to have management include in their 2004 assessment the internal controls over financial reporting for subsidiaries that individually are only debt registrant.
4	P11	N/A	PSEG requests a delay in the effective date of Section 404 of the Sarbanes-Oxley Act due to the delay in the issuance of the final Standards by the PCAOB.
5	P12	N/A	Please clarify whether the term 'significant control' is the same as the term ' key control'. Does management need to test key controls/significant controls or follow the PCAOB requirement that the auditor test controls that are important to fairly present each 'relevant assertion'?
6	P17/ A-25	N/A 56-58	When the activities and level involvement of audit committees will vary depending upon the company and the effectiveness of the company's control environment, additional clarification and/or criteria for management to use to assess the effectiveness of the audit committee is required with respect to: • How well the audit committee and management understand the responsibilities of the audit committee. • Acceptable levels of involvement and interaction with the internal and independent auditor Amount of time that the audit committee devotes to control issues, to committee activity.
7	P17	N/A	Please clarify what is the appropriate period of time for a prior material misstatement, which is subsequently corrected (and disclosed) to be in effect for it to be no longer considered a material weakness.
8	P22	N/A	Please provide additional guidance of what testing is required quarterly for Section 302 and how it aligns with 404 testing. If SarbOx 404 testing results in the identification of a material weakness that will be remediated by management, will it have to be disclosed in the 10Q under Section 302?

PSEG Service Corporation
Request for Clarification
Re: PCAOB Release No. 2003-17

Items	Page #	Std #	Clarification Request
9	A-23/24	50/53	Please clarify whether a company can consider a shared services corporate environment as an activity vs. at a company-level environment. Please clarify whether management needs to evaluate company-level controls or just the auditor.
10	A-35	95	Please clarify whether management can use a smaller sample size for testing than the auditor. Please clarify whether management is required to test year-end processes if they are not significantly different than quarterly processes.
11	A-43	126	Please clarify method to test the effectiveness of the Company's Internal Audit function. Re: Regulatory Compliance – Please clarify what is meant by regulatory compliance function and what framework should be used to assess the effectiveness of regulatory compliance. The Proposed Standards state that 'identification of fraud of any magnitude on the part of senior management' is at least a significant deficiency and a strong indicator that a material weakness exists. Does the PCAOB foresee the submission of a fraudulent expense sheet by a member of senior management rising to the level of a material weakness?
12	A-50	150/151	Please clarify period of time that is adequate to determine whether, as of the end of the fiscal year, the design and operation of internal control over financial reporting is adequate (how long does a remediated process to correct a material weakness have to be in effect for it not to be disclosed?)
13	A-56	170	Please clarify what regulatory compliance is in scope for 404; and what standards should be used to assess compliance.
14	A-93	*Ex B-1*	We noted that in the example the sample size is 25. Please clarify, whether there should be a statistical basis to determine the size of the sample for a large homogeneous population.

Michael J. Ramos
Certified Public Accountant

November 21, 2003

To The Public Company Accounting Oversight Board

Rulemaking Docket Matter No. 008

I found your proposed auditing standard on internal control reporting to be extremely thoughtful and thorough and possessing a clarity of thought and expression that is difficult to achieve in such a complex document. The work of the Auditing Standards board, upon which a good portion of your document is based, was equally impressive. But I feel that you have build substantially upon that earlier work in ways that will benefit the auditors, financial statement issuers and others who will be affected by the final standard. In particular, I believe that you have shown a genuine sensitivity and responsiveness to the issues raised by financial statement issuers about the burdens of complying with the internal control reporting requirements of Sarbanes-Oxley Section 404. I have no doubt that many financials statement issuers will continue to raise strong objectives about the cost of compliance, but I think that even these critics will be impressed with your willingness to consider alternate points of view.

Thank you for considering my comments, which I offer in response to the questions you asked in the proposed standard.

Integrated Financial Statement and Internal Control Audit (Questions 1 – 3)

It is appropriate to refer to the auditor's "attestation" of internal control as an "audit" because the meaning of the term "audit" is more widely understood. To continue to refer to it as an "attestation" would be confusing for the general public. I agree that the auditor should be prohibited from performing an audit of internal control without also performing an audit of the financial statements. Imagine a situation where the internal control audit and financial statement audit were performed by two separate auditors, and the company fails. In trying to determine who should be held accountable, auditor A's defense is "I only audited internal control—I didn't see the financial statements." Auditor B's defense is "I only audited the financial statements." The auditor should be held accountable, and the only way to do that is to require the same auditor to perform both audits.

The suggestion that the internal control auditor could perform work "comparable to that of an audit" seems problematic to me. As a practical matter, what would that work be? Would the general public be able to distinguish between an "audit" and "work comparable to an audit?" It seems that this approach would create more problems than it would solve.

Evaluation of Management's Assessment (Questions 6 – 8)

It is absolutely appropriate that the scope of the internal control audit should consider both management's process for evaluating internal control and the auditor's own evidence relating to internal control. I have always considered that the audit of internal control is analogous to the

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auditor's consideration of an accounting estimate, in that both require the auditor to come to conclusions about subject matter that is primarily subjective in nature. Because of this subjectivity, the auditor should be required to gather evidence from several different sources. Additionally, by requiring the auditor to consider the evaluate management's process, you reinforce the point that management has the primary responsibility for evaluating the company's internal control.

It also is appropriate for the Board to provide criteria that the auditor should use to evaluate the adequacy of management's process, including the supporting documentation. Without this criteria, there would be too much variation in practice, which would undermine the overall effectiveness of the internal control reporting requirements. Moreover, without concreted guidance on what management should include in its process and documentation, the considerable uncertainty over compliance, which currently exists among issuers and auditors, will only persist and fester.

However, I would like to make a suggestion about the guidance that the Board has provided in paragraph 41. In that paragraph, the standard makes reference to controls "on which other controls are dependent." Does the Board intend that the control environment be included in that description? My interpretation is that the term does include the control environment. I base that interpretation on paragraphs 51, 53, and 54, which make reference to controls that have a "pervasive effect" on internal control and to "company-level controls." If my interpretation is correct and the Board does intend for management's process to include an evaluation of the control environment, then the clarity of that guidance may be improved by either making explicit reference to the control environment in paragraph 41, replacing "controls on which other controls are dependent" with "controls that have a pervasive effect…," or both.

Obtaining an Understanding of Internal Control (Questions 9 – 10)

The objective to be achieved in performing a walkthrough is important. Before an auditor can perform an effective and efficient test of the operating effectiveness of internal control, he or she should have a good understanding of what *actually is* happening at the company. Reviewing documentation is insufficient because documentation is a representation of what *should be* happening at the company, which in some cases will be different from what actually occurs on a daily basis. Thus, after reviewing the documentation, an intermediate step is required before the testing of operating effectiveness commences.

I believe that walkthroughs are one way, but not the only way of achieving this objective. For example, I have seen examples where a facilitated focus group with company personnel can be a highly effective way to clarify one's understanding of the way in which documented policies and procedures are "operationalized" at the company. Additionally, it seems that walkthroughs may be rather limited in some situations. Paragraph 80 requires the auditor's walkthroughs to encompass more than just controls activities, but I am having difficulty understanding a walkthrough can be used to address many of the control environment components such as integrity and ethical values, philosophy and operating style, etc.

For these reasons, I thought that the document placed too much emphasis on walkthroughs. I believe that the auditor should be required to accomplish the objectives described as bullet points in paragraph 79, but that the way in which the auditor achieves those objectives should be left to judgment, with walkthroughs being an example of a procedure that may be performed.

Testing Operating Effectiveness (Question 11)

It is appropriate to require the auditor to obtain evidence of the effectiveness of internal control *every year*. Business conditions can change dramatically in a short period of time, and from a practical standpoint, it would seem much easier to require testing every year rather try to provide guidance on the conditions under which the auditor can rely on previous year's testing.

Regarding this general subject matter, I would like to comment on the guidance provided in paragraph 96 relating to interim tests. In addition to the four bullet points listed, I believe that the relative effectiveness of company-wide controls, especially monitoring, also should be considered when designing tests of controls during the "rollforward" period.

Using the Work of Management and Others (Question 12 - 16)

I found your guidance in this area to be excellent. On first reading it, my initial reaction was that it was far too restrictive, in that it did not allow the auditor to rely enough on the work of the company. But upon further reflection, when I really thought through the practical implications of the guidance, I ultimately came to the conclusion that auditors will be able to rely on management's work to a significant degree—though not inappropriate level.

Evaluating Results (Question 17 – 24)

The definitions of "significant deficiency" and "material weakness" will provide for increased consistency because the phrase "more than a remote likelihood" is more consistently understood than the phrase it replaced, "relatively low level of risk."

However, I am somewhat concerned about unintended consequences of this change in terminology. All of the practitioners I have spoken with about this matter believe that "remote likelihood" is a lower threshold than "relatively low level of risk." That is, more deficiencies will be considered to be material weaknesses under the new definition than under the previous definition. I am finding people to be resistant to this change.

I am sympathetic to this point of view and agree that the reporting of more material weaknesses—if that is indeed what happens—will be confusing and disruptive in the short term. However, I believe that this confusion can be overcome with communication and education, and in the long run, we all are better served by a definition of material weakness that is capable of relatively consistent interpretation.

Regarding question 20, I disagree with the proposal to require the communication in writing of all internal control deficiencies (not just material weaknesses and significant deficiencies). The costs of complying with this standard are significant enough. I am not convinced that the benefits of including control deficiencies that are not considered significant in a written correspondence outweigh the costs.

In a related matter, I would like to comment on paragraph 126, specifically the guidance provided in the 4^{th} and 5^{th} bullets. I can understand the Board's rationale for including these matters in the guidance in this paragraph. However, I find the practical implementation of this guidance to be problematic. If the matters indicated in paragraph 126 are to be considered strong indicators of a material weakness, then it seems to me that both the auditor's and management's process for evaluating the effectiveness of internal control should address them. From a practical standpoint, what procedures should the auditor perform to assess the effectiveness of the company's internal audit function? If you require management's and the auditor's process to consider the effectiveness of the company's regulatory compliance function, aren't you, in effect, expanding the evaluation of internal control to include, not just financial reporting, but compliance with laws and regulations? At a minimum, I believe that additional guidance is needed to help auditors and management understand what is required to comply with these two requirements of paragraph 126.

Auditor Independence (Questions 28 – 29)

Initially, I was disappointed in the relative paucity of guidance provided on this matter. This subject has been the subject of much discussion and heated debate, and I was hoping that the Board would provide definitive guidance on this topic. I have since reconsidered my opinion and have come to respect the wisdom of your approach. By putting the onus on the audit committee to decide the matter, you in effect, are letting “the marketplace” decide the degree to which the external auditors will become involved in non-audit services relating to internal control. This seems appropriate to me, especially in light of your comments that you may reconsider the matter at a later point in time. The only suggestion I would make is the addition of “documentation” to the second sentence of paragraph 32. I believe that this addition would be consistent with the emphasis that the rest of the proposed standard places on the documentation of a company’s internal control policies and procedures.

* * * * *

Thank you for the opportunity to participate in this process.

/s/ Michael Ramos, CPA

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 no. 008, *Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting*

Reliant Resources, Inc. ("RRI") appreciates the opportunity to provide comments on the Public Company Accounting Oversight Board ("PCAOB") Proposed Auditing Standard – An audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements.

RRI provides electricity and energy services with a focus on the competitive retail and wholesale segments of the electric power industry in the United States. With respect to the retail segment of the industry, we provide electricity and related energy services to residential, small commercial and large commercial, industrial and institutional customers primarily in Texas. Within the wholesale segment of the industry, we own and operate a substantial number of electric power generating units dispersed broadly across the United States. We also market electric energy, capacity and ancillary services and procure and, in some instances, resell energy-related commodities to optimize our physical assets and provide risk management services for our asset portfolio.

We support the PCAOB's issuance of a new standard on attestation engagements referred to in the Sarbanes-Oxley Act of 2002 ("SOA"). RRI is a member of the Edison Electric Institute ("EEI"), an association of United States investor-owned electric utilities. EEI has issued a comment letter, which we also support. Additionally, we are providing further comments to selected questions raised in the proposed standard below.

Question regarding the costs and benefits of internal control:

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?

The proposed standard provides guidance to support different levels of internal control sophistication that may exist in various organizations. Generally, small and medium-sized issuers may have less complex internal control structures than large global multi-location companies. Smaller organizations may be able to place greater reliance on company-level controls rather than process level control activities.

However, all companies subject to SOA should be able to adequately demonstrate an effectively designed and operating internal control structure that has been tested by management. This requirement should be reinforced in the proposed standard to avoid an incorrect interpretation that small and medium-sized companies have any compliance exemptions.

Questions regarding evaluation of management's assessment:

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

8. Is it appropriate to state that inadequate documentation is an internal control deficiency, the severity of which the auditor should evaluate? Or should inadequate documentation automatically rise to the level of significant deficiency or material weakness in internal control?

An appropriate level of process documentation is necessary to demonstrate that management has evaluated the design effectiveness of internal controls. The actual SOA 404 certification that will be signed by executive management requires an internal control framework to serve as a benchmark for evaluating effectiveness. COSO is a comprehensive framework for evaluating internal controls and is expected to be the default framework for most companies. The control attributes included in COSO for evaluating internal control design include: Objectives, Risks, and Points of Focus for Actions/Control Activities. Proactive companies seeking to improve internal controls may also elect to include other attributes such as Control Type (Preventive/Detective) and Control Technique (Manual/Automated); however, the attributes are not specifically required by COSO.

The criteria for evaluating documentation that is provided in the proposed standard significantly enlarges the volume and expands the depth of attributes beyond the scope of relevant guidance such the SEC Final Rule on Management’s Reports on Internal Control Over Financial Reporting, SOA sections 103 and 404 and COSO. Specifically, the proposed standard requires the design of controls over relevant assertions related to all significant accounts and disclosures in the financial statements. While this may provide some level of efficiency for financial statement audits by linking detailed account level lead schedules to relevant assertions and associated control activities, it adds an unnecessary and significant burden for management to capture relevant assertions at the account level. It would be more appropriate and worthwhile to map the relevant assertions at the financial statement line level, as many organizations already have done to define the processes in scope, rather than account level.

The proposed standard also states the documentation should include the five components of internal control over financial reporting which mirror the COSO components. This requirement may be misinterpreted by numerous organizations erroneously believing that a simple mapping to the five COSO components is adequate for compliance with COSO. Compliance with COSO will require organizations to document and test a control environment for all key processes similar to the defined control activities for the COSO generic business processes, as well as an evaluation of the five COSO components supporting at least the financial reporting category of internal control. Further, the compliance and operational categories must be also reviewed for elements that support the relevant financial statement line items and disclosures.

Sufficient documentation is required to demonstrate an effective control design; however, inadequate documentation should not immediately be deemed a significant deficiency or material weakness. The auditor should exercise judgment based on more refined criteria in making an assessment over the adequacy of documentation. The evaluation should include the extent of documentation, reasons for the potential deficiency and the existence of mitigating documentation. Management should have an opportunity to defend whether or not their documentation meets all material respects of the requirements and how it supports their assessment without a default assignment to significant deficiency or material weakness.

Questions regarding obtaining an understanding of internal control over financial Reporting and question regarding testing operating effectiveness:

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?

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

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?

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?

SOA 404 requires management to perform an assessment of the effectiveness of internal controls and requires the external auditor to attest on management's assertion. SOA 404 does not require the external auditor to perform an unnecessary duplicative assessment of the effectiveness of internal controls as required by the proposed standard. The external auditor should have the flexibility to reperform procedures such as walk-throughs over critical areas to the extent they deem necessary; however, this should not be a rules-based requirement.

The external auditor should not be prohibited from leveraging prior year evidence over the effective design of internal controls provided adequate procedures are performed to review significant changes.

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?

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)?*

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?

As indicated in the responses to questions 6, and 9 – 11 above, reperformance by the external auditor of internal control testing that has already been properly executed and documented with sufficient evidence is redundant and not specifically required by SOA 404.

The proposed standard allows the external auditor to exercise judgment for relying on the work of others based on the objectivity and competency of the company's staff performing the work. A review of the objectivity and competency of staff performing the work would help support the adequacy of management's review and better define the extent of work the external auditor would need to perform. In many cases, a company may have staff better suited, due to their company, industry and process knowledge, to evaluate the effectiveness of internal controls.

Questions regarding evaluating results:

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?

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

Perhaps the most important area requiring focus by the PCAOB in the proposed standard is the definition of control deficiencies, significant deficiencies and material weaknesses. Applying these definitions will require considerable judgment by management and the external auditor and may result in inconsistent interpretation with substantial consequences.

The proposed standard defines a significant deficiency as a single deficiency or combination of deficiencies that results in a more than remote likelihood that a misstatement "more than inconsequential" in amount will not be prevented or detected. This definition appears to be too broad since an amount that is "more than inconsequential" may very well not be material, yet will be deemed a "significant" deficiency. A broad interpretation could result in several companies having multiple "significant" deficiencies that are then inappropriately deemed as a material weakness in the aggregate because the extreme high-end of the range of error of each significant deficiency results in a material amount, even though it would be very unlikely the high-end of the range of error would be experienced for each individual deficiency.

The concept of reasonable assurance is stated in the proposed standard; however, it should be applied to the definitions of significant deficiency and material weakness. The proposed standard states that a high level of subjectivity, complexity, or extent of judgment required for something such as for an accounting estimate increases risk and is a factor affecting the likelihood that a deficiency could result in a misstatement. This guidance can potentially be misinterpreted in numerous situations. For example, if a company with sufficient internal controls to provide reasonable assurance over the accuracy of an estimate has a significant post-close audit adjustment because of new information, then there will be an inappropriate bias towards defining it as a material weakness because of this guidance.

Questions regarding forming an opinion and reporting:

25. Is it appropriate that the existence of a material weakness would require the auditor to express an adverse conclusion about the effectiveness of the company's internal control over financial reporting, consistent with the required reporting model for management?

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

The proposed standard should be modified to not immediately require an adverse opinion if a material weakness is identified. An “except for” opinion may be more appropriate in many circumstances provided the material weakness is properly disclosed and management is taking corrective actions including a successful evaluation evidencing the financial statements were not materially misstated.

The rules-based approach of requiring an adverse opinion when a single material weakness is identified does not provide sufficient distinction for other situations where there may multiple material weaknesses impacting several financial line items. The current requirements would assign both organizations the same adverse opinion.

The proposed standard would be improved by allowing the external auditor to exercise professional judgment in determining the type of opinion to express. For example, if a material weakness is detected, the auditor should be able to assess the impact on the entire internal control environment and consider other factors such as company-level controls.

RRI sincerely appreciates the PCAOB’s willingness to consider and respond to its concerns regarding the proposed standard. We would be pleased to answer any questions regarding the issues outlined in this comment letter.

Sincerely,

Christopher Lozier
Director Internal Control Effectiveness

Risk Management Advisory Services, LLC

Capital markets audit and control

November 14, 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

I am a CPA with 17 years of audit experience, about half in public accounting and half in internal audit. Most of my audit experience has been in performing control audits of business processes and system controls. I am currently working as an independent CPA providing control consulting services. I have no affiliation with any other CPA firms or with any public companies.

My initial reaction to the proposed standard was very positive because the provisions defined a very thorough audit process, coverage of all assertions for all material accounts every year, relying primarily upon the auditor's own work and, most importantly, requirements to audit the controls of the company rather than simply reviewing management's control assessment process.

However, in considering the end result of the proposed process, I question whether the process will add significant value in terms of protecting investors against misstated financial reports because of the inherent limitations of any control audit. The most serious limitation is that control processes can be compromised by "topside adjustments" or other influence and actions by senior management who manage the control system. In fact, if you consider the major accounting problems of recent years (Enron, WorldCom, Tyco, et.al.), the problems were apparently at the top, not in the rank and file.

Furthermore, the cost of the proposed audit process is likely to be high. The proposed standard calls for the auditor to perform a thorough, exhaustive, company-wide audit of internal control. Such an audit is expensive because the auditor must gain a working understanding of so many activities in an organization to be assured that he or she has identified all risks and obtained sufficient evidence of the operating effectiveness of controls.

Therefore, my concern is that the proposed audit standard, despite its excellent value in defining an effective process for auditing internal controls, has the potential to add extensive process and cost without adding corresponding value to shareholders. I think the proposed standard attempts to do too much too broadly while not paying enough attention to the well known and well recognized problems with accounting errors and fraud.

To propose a redirection of the standard, I suggest that the Board consider two categories of corporate accounting control problems: 1) general inattention to controls throughout a company that results in financial misstatements, and 2) deliberate actions, usually by senior officials, to produce a specific financial reporting effect.

I believe that a properly implemented management control assessment process, as defined by Section 404 and the related SEC rules, will fully address the first category. The auditor attestation process becomes an enforcement mechanism to ensure that companies perform this function adequately. Therefore, the standard should define those auditor procedures that are necessary to provide adequate assurance or "enforcement" that management develop, implement, and maintain an appropriate internal control assessment process.

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In an attestation role, the auditor need not review internal controls himself or herself but only needs to verify that management performed a thorough and complete assessment. I believe a rigorous process is appropriate, but the focus should be on evaluating management's annual control assessment. The auditor should reperform some of management tests on a sample basis to obtain sufficient evidence. The auditor should hold management to high standards of documentation for its assessment process, including the risk assessment, identifying all assertions for all material accounts, documenting the control design, planning review procedures and tests, documenting findings, reviewing test results and findings, corrective actions, and final conclusions. This approach puts the primary burden and the cost of assessing internal controls upon management.

For the second category of accounting control problem – deliberate actions to obtain a specific but inappropriate financial reporting effect – a corporate-wide control assessment process will not provide much benefit. To address this problem, the standard should define a process for the auditor to look specifically for evidence of earnings management or other attempts to manipulate the financial statements. For example, the process should include forensic audit techniques and procedures to look at adjusting entries, unusual transactions, decisions regarding accounting treatment, presentation materials and minutes of board and senior management committee meetings, interviews with participants of board and senior management committee meetings, handouts and minutes of meetings to review the accounting close, interviews with persons involved in the accounting close, and similar procedures to provide coverage of areas of possible accounting manipulation.

The process should require the auditor to present his or her findings and conclusions regarding any indication of accounting manipulation to the audit committee. The auditor then should be provided safe harbor if the Board-defined procedures are carried out effectively.

In conclusion, I ask the Board to consider fine tuning its auditing standard to put more focus on known problems (deliberate accounting manipulation) and scale back on the audit requirements that address the broad corporate wide procedures, leaving the main effort for maintaining and assessing corporate wide controls in the hands of management.

I have provided comments on other aspects of the proposed standard in responses to the Board's questions in the attached document.

Sincerely yours,

Bernard Bethke
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Comments on the Board's Questions **Attachment**

I have used the term "attestation review" to designate an auditor process to evaluate management's internal control assessment process and other focused procedures to look for evidence of accounting manipulation.

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?

> Response: No. I would suggest "the attestation review of management's annual internal control assessment."

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?

> Response: No. I believe that Sarbanes Oxley mandates that if a financial statement audit is being performed, the auditor attestation cannot be a separate engagement. However, if no financial statement audit is being performed, the attestation report should be qualified to reflect that the attestation report is normally completed in conjunction with a financial audit, that the financial statement audit might have identified issues that reflect upon the effectiveness of controls, but that no financial statement was performed.

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?

> Response: No. I believe a qualified opinion is a better alternative. It would be difficult to establish a "comparable" process, especially one which did not require a signed auditor certification.

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?

> Response: No. The proposed integrated audit process will require much adaptation for small and medium-sized issuers. An attestation review would be naturally scalable to the size of management's control assessment process. Thus, an attestation review would be fairer to small and mid-sized companies and not hold them liable to the interpretive judgments of their auditors in applying the standard.

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.

> Response: No. I believe existing standards that require auditor competency prior to accepting an engagement and standards to assign competent staff to assignments are sufficient.

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?

> Response: No. This would be redundant and expensive and, in my opinion, provide limited value due to inherent limitations of control audits, particularly that controls might be influenced or compromised by senior officials in a company.

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

Response: I believe it is appropriate for the Board to require criteria and that additional guidance is necessary. The lack of documentation is probably the largest and most costly area of control remediation for compliance with Sarbanes Oxley. However, references to “lack of documentation,” “improving control documentation,” and similar references can be confusing and may allow misinterpretation of the auditing standard. Furthermore, not all types of documentation involved in maintaining internal controls at public companies are equally important. It would be very helpful to define standard terminology and provide further guidance concerning the various documentation requirements.

For example, “policy statements” provide direction and guidance, assign responsibilities, and state the firm’s view on matters. “Operational procedures” describe work to be performed at a level of detail according to needs of the users of the procedure. “Audit trails’ can be defined as documentation of work performed, what was done, who did it, when it was done, conclusions, who reviewed and approved it and when. A “control design” document identifies the policies and procedures that, as a whole, constitute the control structure.

I would suggest that audit trails, a control design document, and working papers for management’s annual assessment are required documentation and that the auditor should not affirm a management opinion that controls are adequate if such documentation is lacking. However, I believe there is considerable latitude when it comes to documenting policies and, especially, operating procedures. This is particularly true in smaller companies, where owner and senior management involvement in many activities can effectively compensate for the lack of documented policies and operating procedures.

My general concern is that companies might perform expensive documentation exercises that add little value to the management and control of the company simple for the sake of “having documentation.”

Internal Control Statements – As a separate matter regarding documentation, would it be helpful or practical to require management to define in a single document a summary of its internal control over financial reporting?

Existing attestation standards require management to produce and provide to the auditor a specific document of its statements and assertions. The independent auditor then performs procedures and tests to form an opinion regarding management’s statements. I suggest that the internal control audit process would be greatly enhanced by a similar requirement.

A summary statement of internal controls puts the burden upon management to identify its key controls. A summary statement provides a tangible starting point for assessing the design of controls and identifying areas to test operating effectiveness. If the Board pursues the proposed integrated audit approach, a summary statement also would enhance the control opinion by identifying the specific statements and assertions that the auditor evaluated in forming his or her opinion.

A standard format might be organized according to the control environment, risk assessment, control activities, information and communication, and monitoring. Each components could include standard subcomponents, such as a code of conduct, an employee reporting process, a self assessment process, the company’s risk assessment process, controls over initiating transactions, review processes, approvals, segregation of duties, data input controls, general computer controls, various reconciliations between internal systems and independent external records, specific monitoring activities, and similar information. Other format standards could tie to major lines of business or to major financial statement categories. If the Board defined a standard format, most companies could provide a summary statement of internal controls in a document comparable in size to their financial statements.

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?

Response: This question illustrates my comment in the previous question about vague references to documentation. I believe the auditor should evaluate the significance of all deficiencies in the context of the specific facts and circumstances at the company. However, it would be helpful for the standard to provide a discussion of the different types of audit documentation and the effect on the overall control structure of the lack of each type of documentation.

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

Response: Yes. Walkthroughs should be strongly encouraged to be performed by the persons conducting the internal control assessment.

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?

Response: No. I think that walkthroughs should be performed by the party that is performing the actual internal control review, which I believe should be management rather than the auditor.

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?

Response: Yes. Management should review and test controls for all relevant assumptions for all significant accounts each year. One might argue for more limited testing if management could determine there have been few or no changes since the prior year. However, there are many things that change (or can change) internally and externally that could cause or allow a significant control deficiency. It would be difficult, if not impossible, to examine and rule out all the possible changes in or around a business function. Therefore, all relevant assumptions should be tested each year.

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

Response: In an attestation review, the auditor should rely solely upon his or her own work.

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

Response: No. These categories and provisions are unnecessary if the auditor performs an attestation review. However, if the process requires categories, I would suggest two categories. Category one would include the work described in paragraphs 104 and 105, including work related to accounts involving significant judgments and estimates. Category two would include work related to controls over routine processing.

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?

Response: No. there is not enough recognition of internal audit competencies and value as one of management's primary tools for maintaining internal controls. This would be remedied by adopting an attestation review approach, at which point management would be able to assign internal audit a wide range of roles in its annual control assessment process.

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)?

Response: Yes. Reperformance should be an important part of the attestation review. However, some additional guidance probably would be needed regarding the extent of reperformance and evaluating the results such as found in Example B-3.

16. Is the requirement for the auditor to obtain the principal 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?

Response: Yes, in that the auditor must rely mostly upon his or her own work in an attestation review.

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?

Response: Yes. The definitions regarding likelihood, such as “more than a remote likelihood,” are helpful. The distinction between “material to the financial statements” and “material to an individual account” is helpful. However, the standard doesn’t seem to add much to existing guidance, which includes a great deal of situational judgment, regarding the definition of “material” itself.

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?

Response: Yes, the examples are generally helpful. However, the materiality is defined in each example and the examples are constructed so that each situation falls clearly into one category or another. The examples do not address the more challenging task, which is to determine materiality of a particular transaction or balance. At some point, it would be good for the Board to review standards and guidance regarding materiality.

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

Response: Yes. It is necessary in order to identify those that are significant. This is true whether in an attestation review or the proposed integrated audit.

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?

Response: For the proposed integrated audit, I believe this seems reasonable to help ensure that the auditor and management pay attention to all weaknesses. I don’t think this is necessary if an attestation approach is adopted.

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

Response: No, not all are appropriately classified. I agree that the first two bullets (restatements and the auditor finding a material misstatement) are “strong indicators” of material control weakness. However, I would not agree that the other bullets necessarily correlate with material misstatement of the financial statements. I think some companies actually have strong controls over financial reporting and good financial reports in spite of a weak audit committee, internal audit department, or regulatory compliance department. Fraud by an individual, if immaterial to financial reporting, could be completely unrelated to financial misstatement. Similarly, the amount of time that a deficiency is outstanding is a factor in determining if it is a material weakness, but each situation should be assessed based on the individual facts and circumstances.

If the purpose of including these circumstances (bullets 3 through 7) in this list is to apply maximum visibility on these conditions to influence change, then another way to handle this would be to label these situations as significant matters subject to SEC disclosure requirements. Or, the Board could include provisions for disclosure of these situations in the internal control reports. At best, I would suggest that bullets 3 through 7 are "indicators" rather than "strong indicators."

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?

Response: No. The audit committee can be an important part of a company's control process; therefore, it is important to review its effectiveness. However, there is a major potential conflict of interest problem in having the auditor assess the audit committee.

The audit committee approves the hiring of the auditor, the fees paid to the auditor, and any non-audit projects to be performed by the auditor. In other words, the audit committee has a great deal of influence over the livelihood of the auditor. In general, the audit committee will get the benefit of the doubt more than is warranted. In the face of a true problem, this arrangement has the potential to create a significant conflict of interest problem for the auditor.

If audit committee effectiveness is important, the Board should consider some other means of evaluation rather than this arrangement which is might fail in the very situation where it would be most needed. For example, the Board might require companies to obtain an assessment of audit committee effectiveness by a different CPA firm, or perhaps by a law firm. The standard would include provisions to ensure the independence of the firm performing the audit committee assessment, such as restrictions on performing other work at the company.

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

Response: No. See response to 22.

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?

Response: No, I do not think that withdrawal should be mandated. I believe each situation must be evaluated according to the facts and circumstances of the situation, the impact on controls over financial reporting, and the impact on the auditor's ability to plan and perform the audit. For example, an audit committee's ineffectiveness might not necessarily impede the auditor from obtaining information, performing planned audit procedures, and developing an informed and professional opinion regarding controls over financial reporting at a company. If an audit committee exercises undue influence or allows management to exercise undue influence or obstruct the audit, then the auditor should withdraw.

As an observation, it appears that the Board believes that audit committees have (or will have) much more control and influence over financial reporting than I have seen in practice.

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?

Response: No. I believe that it would be more informative to investors for the auditor to have the option of either a qualified opinion or an adverse opinion. This is important if the Board is going to strongly encourage the rating of material weakness on matters that (in a specific company at a specific point in time) may not have a direct effect on financial reporting in companies where controls over financial reporting are otherwise adequate.

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

Response: Yes. I believe there are can be material weaknesses (a weakness with a potential impact that is material to the financial statements) where the potential impact would be limited to a defined area of the financial statements or disclosures. For example, if the effect of a material weakness is limited to a particular disclosure while controls over the income statement, balance sheet and other financial statements are adequate, I think it would be more informative to investors to issue a qualified opinion.

27. Do you agree with the position that when the auditor issues a nonstandard 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?

Response: No. I think the public to be better served if the auditor restricts his or her comments to the adequacy of management's control assessment.

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

Response: No. I think the standards are sufficient as stated. However, I support the future study of this issue by the Board, especially to include reviewing actual practice in this area.

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

Response: Yes. As noted earlier, I believe the assessment of audit committee effectiveness should be performed independently from the internal control audit and the financial statement audit. Otherwise, the lists of prohibited consulting activities found in the SEC Final Rule appear adequate. However, I support the Board's plans to review independence matters in the future.

30. Are the auditor's differing levels of responsibility as they relate to management's quarterly certifications versus the annual (fourth quarter) certification, appropriate?

Response: Yes. I think the responsibilities are appropriate for interim quarters as well as the fourth quarter.

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

Response: Yes. I believe these provisions, in that they are substantially similar to existing responsibilities for interim financial reporting, are appropriate.

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October 24, 2003

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

Re: PCAOB Rulemaking Docket No. 008:
Proposed Auditing Standard-An Audit of Internal Control Over Financial Reporting

Dear Sir/Madam:

I am an attorney with no affiliation to any public accounting firm required to register with the Public Company Accounting Oversight Board (the "Board"). I commend the Board on its proposed standard relating to internal control over financial reporting, but offer the following comments on some of the questions posed in its Release No. 2003-017 dated October 7, 2003.

Question 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?

Comment: No.

In proposing that an audit be made of internal control over financial reporting (hereafter such type of controls referred to simply as "internal accounting controls" or "internal controls"), the Board has interpreted relevant provisions of the Sarbanes-Oxley Act (hereafter the "Act") broadly and perhaps unnecessarily so at this point in time. It has also blurred the difference between an "attest" service and "attestation report" as compared to an "audit" and "audit report."

The Act contains two provisions concerning internal accounting controls: First, Section 103(a)(2)(A)(iii) provides that the Board include in auditing standards it adopts a requirement that the outside auditor "describe in each audit report *the scope of the auditor's testing* of the internal control structure and procedures of the issuer, required by section 404(b) [of the Act]... Second , Section 404, entitled "*Managements'* Assessment of Internal Controls," and subsection (b) thereof, entitled "*Evaluation* and Reporting", require the outside auditor to both "*attest to*" and "*report on*" "*the assessment made by management...*" It further provides that such attestation "be made in accordance with *attestation standards*" adopted by the Board. (Italics added).

An "attest" engagement" concerning matters other than the financial statements has traditionally been distinguished from an "audit" of the financial statements. The former usually refers to an engagement in which the auditor "expresses a conclusion about the reliability of a written assertion" made by others. See Statements on Standards for Attestation Engagements ("SSAE") promulgated by the AICPA and codified as AT Section 100.01. Its standards further distinguish the attest function of an "audit of financial statements," on the one hand, from those other kinds of "attest" services that provide "assurances on representations *other than historical financial statements and in forms other than the positive opinion,*" on the other hand. See Introduction to Attestation Standards. It makes clear that attesting to the effectiveness of internal controls is a typical example of such other "attest" services. A comparison of attestation standards and audit standards is set forth as Appendix A in AT Section 100.89.

The SEC has also traditionally distinguished between an "audit" which it has used to refer to an examination of the financial statements, on the one hand, and "performing other...attest services for the issuer," on the other hand. See text and footnote 62 in Securities Act Release No. 8173, "Standards Relating to Listed Company Audit Committees", dated January 8, 2003. Moreover, in its recent release adopting rules for management's report on internal controls required by Section 404(a) of the Act, the SEC refers to the auditor's report on management's assessment required by Section 404(b) as an "attestation report" which is to be made in accordance with standards for "attestation engagements" . It has also amended Regulation S-X to define the term "attestation report.". See Securities Act Release No. 8238 dated June 5, 2003 and Rules 210.1-02 and 210.2-02 of Regulation S-X.

Thus, to avoid confusion between the SEC's rules and the Board's standards, and to more closely follow the exact words used in Section 404(b) of the Act, the Board may wish to consider calling the auditor's report an "attestation report" on management's assessment of internal controls rather than referring to it as an "audit" of internal controls over financial reporting which results in an "audit report".

The Board's proposed standard explains in Paragraph 3 and footnote 3 that the terms "audit" and "attestation" "refer to the same professional service, one being the process and the other the result of that process." I am not an accountant but believe that an "audit" of financial statements is a form of "attestation"and that the concept of "attestation" is almost indistinguishable from "auditing." Both require an examination, testing, gathering of evidence and opinion determining if managements' assertions are "fairly stated in all material respects" or "fairly presented." See AT Section 501, "Reporting on an Entity's Internal Control Over Financial Reporting" and AT Section 9501. However, attestation standards have traditionally been issued to "provide a framework for the attest function beyond historical financial statements." AT Section 100.89.

In view of this history and the confusion that might result from having Board standards using terminology that differs from both those customarily used and from those used in SEC's rules, it may be more appropriate (and practical) for the Board not to use the word "audit" or "audit report" when referring to the auditor's attestation of management's assessment of the effectiveness of internal control over financial reporting.

Question 6. Is the scope of the audit appropriate in that it requires the auditor to both evaluate management's assessment and obtain, directly, evidence about whether internal control over financial reporting is effective.

Comment: No.

Related to the use of terminology, and proceeding from it, the Board's proposed standard would require the auditor not only to evaluate management's assertion as to the effectiveness of internal controls, but also to independently determine, after obtaining direct evidence, that they are in fact effective. The Board asks if this scope of the audit is "appropriate."

It should be noted that historically there has been a distinction between the auditor directly expressing an opinion on the effectiveness of internal controls as compared to whether management's assessment of their effectiveness is fairly stated. See the AICPA standard in AT Section 501 (which the Board's standard would supercede). The difference is also highlighted, to some extent, by the General Accounting Office's May 20, 2003 comment letter to the AICPA's Auditing Standards Board ("ASB") on its exposure draft standard dated March 18, 2003. The GAO stated that although it believed in the value of an opinion on internal controls and has provided them for financial statement audits it conducts, it also pointed out: "Current guidance for audits of government agencies and programs requires auditor *reporting* on internal controls, *but not at the level of providing an opinion on internal control effectiveness.*" (Italics added).

Due to this historical background and traditional distinction, I believe it may be argued that at the time the Act was enacted Congress did not intend that an audit be conducted of the internal controls and that the auditor itself opine as to their effectiveness. If it did so intend one would have expected the Act expressly to so provide. Instead, it uses the words "attest to" and "report on" "*the assessment made by management*" and, further, that such attestation be made in accordance with “attestation standards” adopted by the Board. (Italics added).

Question 11. Is it appropriate to require the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year or may the auditor use of the audit evidence obtained in previous years to support his or her current opinion on management’s assessment?

Comment: No.

The Board’s proposed standard requires testing of “all” relevant assertions concerning “all” significant accounts and “all” significant disclosures. This seems to adopt the ASB’s position concerning the extent of the controls to be tested in an audit of them as compared to one of the financial statements. Thus, in its March 18, 2003 exposure draft, the ASB contends that significantly greater testing is required when doing an audit of internal controls as compared to an audit of the financial statements, stating:

> “6. The range of controls that need to be tested to express an opinion on internal control is *significantly broader* than that which may have been tested solely to express an opinion on financial statements. For example, [for the latter]...the auditor may elect to perform only substantive procedures rather than to perform tests of controls, or perform a mix of substantive procedures and tests of controls over some or all significant accounts, classes of transactions, and disclosures... For the purpose of expressing an opinion on internal control, the tests of controls should encompass significant controls related to all significant accounts, classes of transactions, and disclosures...” (Italics added).

(The Board has changed the ASB standard by requiring that all “relevant assertions” rather than “significant controls” be tested in the audit of internal control).

Such a significantly broader view of the controls to be tested, however, may be inconsistent with Section 103(a)(2)(A) (iii) of the Act which requires that the auditor’s report describe the “scope of the testing” of both controls and procedures, words that probably suggest a limitation was intended. The argument would be that if Congress intended that “all” significant assertions related to all significant accounts and disclosures be tested, it would not have used the words “scope of the testing”.

In view of the foregoing responses to Questions 1, 6 and 11, and for the reasons set forth below, I believe the Board should consider proposing a standard at this point in time which only requires the auditor to examine "management's assertion" of effectiveness and evaluate whether it is "fairly stated in all material respects". To reach its conclusion, the amended standard would require the auditor to test "certain" controls and procedures but only to the extent necessary to gather evidence to corroborate or refute management's assertion. I believe that such a standard would more closely follow the Act's references in Section 404(b) to an "evaluation" of "the assessment made by management" and Section 103(a)(2)(A)(iii)'s requirement that the auditor's report describe the "scope of the testing".

Such an amended standard should significantly reduce the outside auditor's work and fees, and thus significantly reduce the costs imposed on the approximately 15,000 large, medium-sized and small public companies affected by the Board's standard. It would also allow the Board to proceed on a more cautious basis and discover over the next few years whether such an attestation standard has positive results before a more demanding one is adopted. Of course, such a decision is essentially a policy one and in its start up phase and in light of the horrendous audit failures that led to the Act's enactment, the Board may decide it must impose the most stringent standard possible.

It should be noted, however, that the Board is not the only body that Congress has vested authority in, or responsibility for, improving internal controls over financial reporting. Management must not only report on the effectiveness of internal controls under Section 404(a) of the Act, but under Section 302 must also take responsibility for such controls and certify their conclusions as to their effectiveness. And, under Section 906 of the Act, there are criminal penalties attached to management's knowingly false certification. Thus, the Board's rules in this area should be considered in light of these other stringent requirements.

If, despite these new requirements imposed on management, the Board finds from experience that its attestation standard fails to improve internal accounting controls and the reliability of financial reporting, it will have sufficient reason and ample evidence to warrant the more rigorous standard of requiring an audit of internal accounting controls by the outside auditor with a direct expression of its opinion as to their effectiveness.

Question 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?

Comment: No.

While the Board states it is "sensitive" to its possible effects on such entities and recognizes that "one size does not fit all", it does not give any *specific guidance* to how audits of internal accounting controls may be conducted for such smaller and medium-sized companies. For example, it could propose that "walkthroughs" of "significant processes" be required for only a *sample* rather than to "all" of them. It could also require the testing of controls of a *sample* of "relevant assertions" for all significant accounts or disclosures rather than testing "all" such assertions for all such accounts and disclosures.

Without the Board providing specific guidance, the outside auditor of a small or medium-sized company will fear doing less than all "walkthroughs" and testing controls of "all" relevant assertions about "all" significant accounts and disclosures. Thus, the Board's concerns that small and medium-sized companies not be subjected to the same extensive testing as larger companies will be ignored unless it gives guidance to the outside auditor to perform less.

Question 10. Is it appropriate to require that the walkthroughs be performed by the auditor himself, rather than allowing the auditor to use walkthrough procedures performed by management, internal auditors or others?

Comment: No.

It is not appropriate for the Board to only permit such procedures to be performed by the outside auditor. If a company has a professional and independent audit staff it may be in a better position than the outside auditor to understand the internal accounting controls and how they perform. The central question is whether it would be "reasonable" for the outside auditor to rely upon the internal auditor staff. If that staff follows professional standards, such as the Standards for the Professional Practice of Internal Auditing issued by the Institute of Internal Auditors ("IIA"), reports to the audit committee and is deemed independent of management, the outside auditor should be allowed to rely, to a significant extent, on "walkthroughs" already performed by it rather than re-doing its work. To determine what is "reasonable" reliance, the outside auditor could re-do a sample of those done by the internal staff. This position is consistent with the Board's proposed standard in Paragraph 103 concerning relying on internal auditors for the tests of controls "to the greatest extent an auditor could use the work of others."

Question 22. Is it appropriate to require the auditors to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting?

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

Comment: No.

Such a requirement would reverse the "master-servant" relationship that should exist between the audit committee as “master” and outside auditor as “servant” and is contrary to the objectives of the Act to strengthen the role of the former. I believe such a requirement would dilute the audit committee’s power and authority if it could be questioned and evaluated by the outside auditor it is supposed to supervise.

I also think it is impractical to require that the audit committee charged by Section 301 of the Act with responsibilities for hiring the outside auditor, approving of certain non-audit services, including tax services, it wishes to provide, retaining the sole authority to fire the auditor, and resolving disagreements between the auditor and management regarding financial reporting, be simultaneously evaluated by that auditor, particularly as to its effectiveness in overseeing such financial reporting.

In June 2002, a committee appointed by the New York Stock Exchange made a set of recommendations about improved corporate governance, stating with respect to the role of the audit committee:

> “...the committee stands at the crucial intersection of management, independent auditors, internal auditors and the board of directors.”

In view of its significant and critical role, I would urge the Board to drop from its proposed standard any requirement that the auditor evaluate the audit committee’s effectiveness.

Respectfully submitted,

Robert Chira

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Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re: Rulemaking Docket Matter No. 008

Dear Sirs,

We at Safeway are pleased to have the opportunity to comment on the proposed Auditing Standard, PCAOB release No. 2003-17.

After careful consideration of the draft we are supporting the comments being submitted separately by Financial Executives International. I am a member and believe that organization represents well a large constituent body of implementers of the final standard.

However, we do have one observation about which we feel strongly and wish to emphasize.

We disagree with the proposal to have auditors review the audit committee performance. No matter what arguments you construct to support that it may be possible to objectively accomplish such a review, the optics are horrible. It is inappropriate for someone to assess the performance of the body responsible for their ongoing employment. A skeptical public will not believe it can be done, particularly in today's environment.

Thank you for the opportunity to comment.

Sincerely,

David F. Bond
Senior Vice President – Finance and Control

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October 27, 2003

Office of the Secretary
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RE: PCAOB Rule Making Docket Matter #008

These comments are based on experience as a public member of several accounting groups and of numerous public company audit committees.

This proposed auditing standard represents one of the most important regulatory step by the Board. The Board's release demonstrates that it brings careful analysis and a balanced approach to this important matter. My comments focus on several areas of the Board's proposal and concludes with discussion of a policy issue that the Board may want to think about:

An integrated audit of both the financial statements and internal controls over financial reporting makes sense both on the grounds of effectiveness and efficiency. For too long, there has been a lack of understanding by auditors of how much knowledge auditors need about internal control and the nature and extent of control testing. As an audit committee member, I frequently noticed that auditors paid little or no attention to the clients' internal control systems.

With this standard, there should be no longer be any misunderstanding about the relevance of internal control to an audit and how internal control should be considered in the course of performing an audit. Moreover, this proposed standard will clarify for investors the role of the auditor in attesting to management's assessment of internal controls and the degree of internal control work that auditors must perform in connection with their audit of financial statements.

My major problem with the proposed standard is the lack of emphasis on major areas susceptible to fraud risk in planning an audit of internal controls. In the O'Malley Panel report, we pointed out the need for some kind of "forensic" type procedures for every audit to enhance the prospects of detecting material financial statement fraud. In planning an audit of internal controls, the auditor should ask where is the entity vulnerable to the override of internal controls by management. The Board may want to integrate this standard on the audit of internal controls with an audit standard designed to detect internal fraudulent financial reporting.

On page 6 of its proposal, the Board states that, for smaller, less complex companies, auditors can exercise reasonable professional judgement in determining the extent of the audit of internal control. Why shouldn't this statement relating to professional judgment apply to all internal control audits and not just to those of smaller, less complex companies?

The requirement in the proposal that the auditor evaluate the effectiveness of the audit committee's oversight may be correct in theory but unrealistic in practice. The only alternative for the auditor who concludes that the audit committee's oversight is inadequate is to report it as a material weakness to the full board or to resign. I doubt that the auditor will do either. What the auditor should do is to highlight for the committee its responsibilities in a subtle but pointed way. I would omit this part of the proposal.

I agree with the approach taken by the proposed standard that the auditor can provide an internal control related non-audit service to an audit client if it has been specifically pre-approved by the audit committee. When the Board gets around to dealing with the independence issue, I would hope that it would permit audit committees to pre-approve internal control related non-audit service as a category. In this connection, the SEC pronouncement on auditor independence needs rethinking by the Board.

In conclusion, there is a broader policy issue the Board might want to think about, i.e. how does the Board see its role in setting audit standards. In the case of this proposed standard, the Sarbanes-Oxley Act requires the Board to establish professional standards governing the auditor's attestation of the effectiveness of internal control over financial reporting. However, does it make sense for the Board and its staff to establish all audit standards for public companies? The number, variety and complexity of auditing standards pose an enormous task for the Board's staff and could place the Board in the position of creating something analogous to the IRS Code and Regulations. It would seem to me wise for the Board to play an oversight and monitoring role with respect to most standards and to delegate the primary task to professional groups who have the knowledge, experience and flexibility to do the heavy lifting in standard setting.

Very truly yours,

cc: William J. McDonough, Chairman

4701 Asbury Park Terrace
Louisville, KY 40241

November 20, 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

Ladies and Gentlemen:

As a current Board and Audit Committee member for several publicly-traded companies and as a former CEO of a publicly–traded company, I read your proposed exposure draft on internal control with great interest. I was particularly interested in paragraphs 56 through 59 related to the evaluation of the effectiveness of the Audit Committee's Oversight of the Company's External Financial Reporting and Internal Control Over Financial Reporting. While I agree that the audit committee plays an important role within the control environment and is essential to setting a positive "tone at the top," I believe that requiring the independent auditors to evaluate the effectiveness of the audit committee introduces an inherent conflict of interest that could have a detrimental effect on achieving one of the ultimate goals of this proposal, ensuring the integrity of a company's financial reporting. Under the Sarbanes-Oxley legislation, the audit committee is required to hire and fire the independent auditors and evaluate their qualifications and performance. Now, under this proposal, the independent auditors are put into the position of evaluating those who hire and fire them. I believe this would make each party wary of each other and impede the direct and open communication that is necessary between the audit committee and the independent auditors to fully fulfill each set of responsibilities.

Further, I believe that it would be very difficult for many of the factors cited in paragraph 57 to be evaluated, particularly the specific requirement to evaluate of the level of involvement with the independent auditor, including the appointment, retention, and compensation of the independent auditor. I don't believe any independent auditor can carry out this responsibility without being accused of an inherent conflict of interest.

Finally, I agree with and believe that it makes great sense for the independent auditors to consider the activities of the audit committee as part of the evaluation of the control environment; however, I don't see how an evaluation of these activities, *alone*, could lead to a conclusion that a "significant deficiency and a strong indicator that a material weakness in internal control over financial reporting exists." I believe there are many other factors that should be considered in the determination of a significant control deficiency.

Please note that these are my personal comments and should not be attributed to any university nor to any corporations on whose boards I set. If you have questions or comments please contact me directly.

Very truly yours,

Roger W. Schipke

To: Public Company Accounting Oversight Board

From: Larry J. Scott, CPA
13831 Grey Friars Lane
Midlothian, Virginia 23113

Subject: Response to Proposed Standards for the Audit of Internal Controls
Docket Matter No. 008

Date: November 19, 2003

Please find attached my responses to the 31 questions outlined in the proposed internal control auditing standards.

I applaud the efforts of the Board in establishing new standards. I appreciate your efforts to be fair and reasonable regarding implementation of the new standards and the opportunity to respond to the proposals. I would also encourage the Board, as I am certain you will, to take due care in finalizing the new requirements by considering all respondents concerns, including the costs (both external and internal) to implementing the new rules.

In conversations with many colleagues, as well as those in public accounting, I get the impression of grave concern that the new requirements will significantly increase external audit fees as well as use valuable internal resources to implement the new standards. The rules were established to restore investor confidence in financial reporting and hence require the involvement of management and the public accountants in the audit process, with which I firmly agree. The Board, however, must be diligent in its oversight (both of the auditor and of management) to ensure that the new standards (however good intentioned) are focused on the objective and not merely a method to restore fees to the public accounting industry.

I am the Vice President, Audit of a mid-size listed company. The opinions expressed in this response are mine and may not necessarily reflect the opinions of my employer.

Sincerely,

Larry J. Scott, CPA

**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
PCAOB Rulemaking
Docket Matter No. 008**

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?

Yes. Not only is it appropriate, some investors have likely been under the impression that the external audit of financial statements was also an evaluation of a company's internal controls.

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?

No. However, an audit of the financial statements should require the same external auditor to express an opinion of the financial reporting controls.

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?

Yes, but if PCAOB truly believes that this process is an integrated audit then there should only be a single audit resulting in a single opinion.

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?

No. Not only does the proposal not address smaller public companies, it does not adequately address the concerns of larger companies.

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.

No. While clearly a junior person should not interview a senior executive for several reasons, the level of competence is a function of cost and quality. This would be best left to company's representatives and the public accountants to negotiate staffing and an appropriate fee structure based on quality of work, hours required, and issues identified during the audit.

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?

No, the scope content is too broad. Public companies will be at the mercy of public accountants that will no doubt interpret the rules to mean more work rather than less.

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

Yes, but as discussed above, the criteria must be very specific.

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?

Inadequate documentation of a "significant process" or a "material location or business unit" should be evaluated by the public accountant along with the company's management, but may not necessarily be a material weakness. Inadequate documentation should not automatically escalate to a significant deficiency absent an examination of materiality

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

Yes, for routine transactions. However, for non-routine transactions a walkthrough would not be helpful. In fact, most non-routine transactions of a material or significant amount are the subject of "substantive audit" work already performed. Therefore the walkthrough is redundant and adds additional cost to the audit.

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?

No. It is not necessary that the auditor perform all the walkthroughs and should use management. Again, this is too broad and will no doubt be interpreted by the auditors as requiring walkthroughs of all processes regardless of significance. Also as stated above, the testing should not be required for all material or significant processes and or locations on an annual basis.

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?

The standards should be constructed so that the auditors are not required to perform detailed testing of all significant processes or locations on an annual basis. History of testing by both management and the auditors in prior years and prior quarters of the current year should be encouraged. In formulating an opinion on the financial statements (and internal controls for financial reporting) the auditor relies on prior experiences to determine scope and extent of work. Therefore, use of prior years work is essential and should be a part of determining scope in the current year.

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

Auditors should be required to review the work of management and others in the process to a large extent. If performed properly, this will not only serve to control fees but also result in improved audit results. Many companies have continuous process improvements efforts. If done right, 404 compliance can be made easier, result in better audits, and benefit the company through lower fees. Moreover, the level of experience in a typical public accounting staff is such that reviewing the work of others is preferable to performing their own work blindly with very minimal experience and even less specific client knowledge.

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

No. Be more specific! Control points # 2 and #3 performed jointly with the auditor and management or others lends credibility to control point #1 (the control environment). Therefore, use of management and others to evaluate the environment, risks, etc is and should be appropriate.

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?

No. However, PCAOB must clearly define in detail what is "sufficient" work for the auditor to perform so that inappropriate work is not performed and a reasonable level of comfort is attained. Many internal auditors perform work that go well beyond the scope of an external financial audit. However, much of this work goes unappreciated and unused given fee considerations and perceived scope of the external work. Moreover, the institutional knowledge developed by a good internal auditor goes largely unused and unappreciated.

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)?

No. Again, this will result in broad interpretation. PCAOB should be more specific in this area.

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?

No. The auditor is and should be held responsible for the principle evidence. However, the process used to obtain that evidence is subject to many interpretations by the auditing profession. PCAOB should specifically define the benchmark.

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?

Yes. However, clearer definition is essential. Communicating to the Audit Committee should be done on only significant findings. Insignificant weaknesses or immaterial errors should not be the focus. Much time and money will be expended in determining what should be elevated to the Audit Committee. As regards Audit Committee effectiveness, "who" will set the standard? PCAOB should establish specific benchmarks for the evaluation.

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?

N0. For example, say a company has several large US locations and many of the transactions are processed centrally. From a materiality point of view all locations are significant and the centralized process is therefore significant. A transaction processing error at one location (assuming that it is detected and corrected) should not necessarily be relevant to the entire population of transactions and locations and thereby lead to a conclusion that the process and the location are not "in control".

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

No. The auditor in the audit planning process should develop and draw on past experiences from prior years' audits. From that planning process the auditor should be able to evaluate and obtain comfort as to managements' evaluation of deficiencies.

20. Is it appropriate to require the auditor to communicate all internal control deficiencies (not just material weaknesses and significant deficiencies) to management in writing?

No. Only material or significant weaknesses should be communicated to management or to the Audit Committee as well.

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

Yes.

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. It is appropriate. However, the Board must carefully consider the consequences to management and the Board of Directors. Audit Committees rely on management and other sources, such as the independent auditor, to perform their oversight roles. Presentation of such an evaluation, especially if negative or presented incorrectly, could create issues between management and the Board that go beyond financial reporting. In my experience, sometimes the auditors are ignorant of monitoring and other internal controls that are the responsibility of the full board or another committees of the board. For the above reasons, it would be preferential to require the Audit Committees to perform a self-evaluation and review with management and the auditors and solicit feedback from both. This would then be similar to the governance requirements of Board self-evaluation required by the NYSE.

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

No. Public accountants do not have the requisite skills to perform such an evaluation. PCAOB should develop the criteria and benchmarks. That evaluation should be performed jointly with management and the Committee and not in a vacuum. PCAOB should be very specific in directing the evaluation. See comments to #22 above.

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 comment. Both options have severe consequences. If a company has an ineffective Audit Committee, there would moat likely be other very significant issues for the Board to address. PCAOB should be more concerned with the accuracy and fairness of the evaluation.

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?

No. The auditor should report only on material weaknesses as required in management's report. Again PCAOB must be very specific as to the definition of materiality.

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

No. If the definitions are clear and the standards for execution of the audit clearly defined, then management and the auditors should be able to conclude on the facts and issue the appropriate conclusion. However, PCAOB should give clearer guidance on disagreements over what is or is not material and significant and the resolution.

27. Do you agree with the position that when the auditor issues a nonstandard 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?

If the auditors are allowed to issue a nonstandard opinion, then they should speak directly to financial reporting. However, as mentioned in #26, clear definition is needed. Also, PCAOB should clearly address resolution of different opinions between management and the auditors over material weaknesses. For example, should management in its report have the ability to disagree with the auditors' conclusion and if so, how should the format of such a dissent be articulated?

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

Yes.

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

Yes. All internal control work should be disallowed beyond formulating the opinion on the financial reporting control as part of the annual audit.

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. However, I do not agree with the conclusion that a promptly corrected material weakness need be disclosed.

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

Yes. Again however, if the material weakness is promptly corrected I see no compelling need for disclosure.

From: Rod & Vicky Scott [rodvickyscott@yahoo.com]

Sent: Wednesday, October 29, 2003 9:22 AM

To: Comments

Subject: PCAOB Rulemaking Docket Matter No. 008

Comments on PCAOB Proposed Auditing Standard October 7, 2003

I think that the definitions and, particularly, the examples are well done. However, there are two areas I would like to see clarification.

I am teaching a class for the IIA on the impact of Sarbanes-Oxley on Information Technology. I also consult in the area and have found that deficiencies that are identified in information technology continue to be dismissed by the external audit firms as not material, regardless of their severity.

In one case, the computer room which operated all of their business systems was in the middle of an office under the same sprinkler system as the office and vulnerable to a smoke alarm in the bathrooms which would dump water on the equipment without notice and destroy the hardware and software and data for an extended period of time. This was compounded by lax network security which allowed the business computer to be exposed to the Internet and a lax security administration which allowed third-parties to access the business systems remotely as security officers. The comments of the external auditor were that there was nothing "material" in the IT area.

I would like to see some **example of a weakness in IT internal controls that should be considered a significant deficiency, material weakness, or aggregation of significant weaknesses** so that we do not go forward with the old external audit concepts of materiality.

Another area I would support clarification is the ability to rely upon the work of the internal auditors or other third parties in attesting to the client's internal controls. As a practical and economic matter the external auditors must rely upon these parties and verify that their work was rigorous. In some areas such as record retention (Section 103 of the law), the companies must be the custodians of most of the records being retained. Internal IT audit functions or third-party consultants can provide cost effective, knowledgeable manpower alternatives to fulfill the intent of Sarbanes-Oxley.

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From: Morrison, Tim TDR SI-FC [Tim.Morrison@shell.com]
Sent: Friday, November 21, 2003 1:10 PM
To: Comments
Subject: PCAOB Rulemaking Docket Matter No. 008

Comments on PCAOB Rulemaking Docket Matter No. 008; Proposed Auditing Standard

Thank you for your invitation to provide comments on the proposed auditing standard *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* as published by the PCAOB on 7th October 2003.

Control environment:

The Royal Dutch/Shell Group has for many years operated a risk based control environment, which includes controls on financial reporting. One of the key benefits of this is that it helps ensure that control resources are devoted to the right areas. It also supports an environment in which management throughout the organisation is actively responsible for the maintenance and application of controls. The Group has a strong desire that any changes reinforce this environment and that we avoid changes which may erode it, for example through attention being devoted to lower value or lower risk activity.

We have some general observations and some more detailed ones which are in an appendix to this email.

General Observations

A. Role of auditors

We believe that an integrated approach to auditing of financial statements and attestation of management's assessment of the effectiveness of internal control over financial reporting is appropriate.

We are however concerned about the potential for a significant level of duplication of management and external auditor testing. We feel that for efficiency and cost effectiveness and more swiftly to identify those areas of concern to focus on, the external auditor should be able to use their judgment to assess when and where they may rely upon the work of others, by doing sampling of an appropriate nature to verify that reliance may be made. If management's testing is objectively documented and clearly evidenced, and sample testing verifies the results, no further duplication of effort should be required or mandated.

We generally feel that the document seems to be overly limiting the ability of the external auditor to use their judgment to rely on other work. While some comments seem encouraging about less work required for companies that have good controls, other statements seem to substantially negate that.

B. Significance criteria

Equally as important is the significance criteria defined in the Proposed Audit Standard. The Standard defines a stepping down process for setting the scope of the internal controls audit that includes identifying the significant locations, significant accounts, relevant assertions, significant processes, and finally to the controls to test. In paragraph (8) a significant deficiency is defined as one that "results in more than a remote likelihood of a misstatement of the company's annual or interim financial statements that is more than inconsequential in amount". The Appendices show an example of a significant deficiency where the impact is more than inconsequential, but less than material. Taking all this together results in a very detailed scope of assurance and testing, with the result that weaknesses which are non material in any practical sense will need to be attended to with high priority in order to avoid a qualified opinion of the enterprise's control framework, one which would in fact be misleading (a 'false alarm') to users of the accounts.

We believe that this is too broad and we strongly recommend that the more than inconsequential measure be replaced with a higher standard consistent with the notion that these are significant deficiencies (i.e. replace “more than inconsequential” with “significant”). This will not result in material matters going unattended and will release effort to be devoted to preventing or handling material problems.

C. Intended focus on controls on financial reporting

Paragraph (24) directs the external auditor to evaluate all controls specifically intended to address the risks of fraud that are likely to have a material effect, paragraph (43) directs the external auditor to evaluate documentation of controls designed to prevent or detect fraud. Financial controls have their beginnings and basis in the prevention of fraud so this appears to widen the scope to all potentially material controls, not just controls on financial reporting. We propose that the requirement be limited to prevention and detection of fraudulent practices in connection with financial reporting, since that is the matter dealt with by S.404.

We hope that our overall recommendations and our detailed observations are helpful in the development of workable and effective regulations and we appreciate the opportunity you have provided to submit these comments.

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Appendix

Detailed comments

Unless otherwise indicated, the detailed comments are given in response to the questions raised by the PCAOB in the preamble to the Proposed Standard.

1-3 We believe that an integrated approach to auditing of financial statements and attestation of management’s assessment of the effectiveness of internal control over financial reporting is appropriate.

6 It is appropriate for the external auditor to obtain some direct evidence about whether internal control over financial reporting is effective. However, the external auditors should be able to rely upon clear evidence from a viable internal control system that can be verified. They should not be required to do significant repeat testing, thereby duplicating effort, for their test results.

8 We feel that external auditors should be able to use their judgement on whether inadequate documentation is an internal control deficiency. Documentation enables the control(s) to be repeated or audited efficiently (and therefore cost effectively), but the lack of documentation does not in itself mean that the control is not operating effectively.

9 The performance of walkthroughs may assist understanding of the operation of the controls in place, however they should not be mandated since there may be better systemic ways of gaining a similar level of understanding.

10 If the results of management walkthroughs are clearly and objectively documented, we see no reason why external auditors should not be able to rely on management's results, having carried out sample testing to verify reliability.

11 Prior year evidence should be available to management and external auditors to form a conclusion on the scope of the testing to be carried out in the current period. Sufficient sample testing of the prior year evidence to ensure that it remains valid would enable reliance to be placed on that evidence.

12 The judgement of the external auditors should determine the extent to which they are able to rely on the work of management and others. The external auditors should not be duplicating the testing of management or others except on a sample basis to inform that reliance, with sampling done to confirm not recreate evidence of the controls operation.

13 There should be no categories of controls in relation to which the work of management and/or others specifically cannot be relied upon once sample testing by the external auditor has verified the evidence. Individual, and groups of, internal controls do not necessarily fall into single categories of controls. The judgement of the external auditors in making the assessment described in paragraph (103) should determine where reliance may be made.

14 There should be no difference between the approach used to test and place reliance on internal audit work and that of management or others.

15 Re-performance of tests should be left to the judgement of the external auditors, not mandated. Other forms of testing may be more informative and effective than repeating the same tests as carried out by management or others.

16 It is unrealistic and inefficient to require built in duplication of management and external auditor's work. Verification through sample, or other, testing should enable the external auditors to determine the level of reliance that may be placed on the work of management and others.

17 The definitions of significant deficiency and material weakness are too broad to limit the scope of review to those areas that are significant or material in the normal use of those terms (being a small number of 'important or noticeable' items or those 'having a special meaning'). The meaning of 'not inconsequential' is not clear and is not available in other accounting and/or auditing guidance. It sets a very low threshold, which is in conflict with the concept of 'significant' or 'material'. The definitions would be improved by providing a more focussed approach to identify what is significant and material.

19 It is not clear what is meant in paragraph (116) by the necessity for the external 'auditor to evaluate identified control deficiencies'. Reliance should be placed on managements evaluation once confidence in the management and processes has been reached.

20 If management have already identified and communicated internal control deficiencies it is not appropriate for the external auditors to do so again. The external auditor should communicate only those deficiencies identified that have not been identified by management, or that have not been communicated to the Audit Committee.

22-23 Requiring the external auditors to evaluate the effectiveness of the Audit Committee, that appoints them and is responsible for overseeing their activities, seems to put the external auditors in a position with potential for conflict of interest.

25-27 These questions need to be addressed from the standpoint of the user of the accounts. If the rules which determine a material weakness to exist are so tightly drawn as to result in a material weakness being reported, and therefore an adverse report finding, but which is one which does not in fact represent a material threat to the health of the enterprise, then the false alarm does not serve the user well. Somehow a balance needs to be found between a standard which encourages enterprises to ensure their controls are fit for purpose and one which causes warning lights to go on unnecessarily. We do not exclude here material weaknesses which, though currently minor in impact, may nonetheless serve as early warning of problems to come; these should be the subject of disclosure. Because the SEC has eliminated flexibility in how to handle a material finding, the onus is on the PCAOB to define what constitutes material very carefully.

31 Since foreign registrants are not required to certify on a quarterly basis and since in many cases, including that of the Royal Dutch/Shell Group, quarterly releases are unaudited, we assume that the reference to quarterly work is only applicable to companies which certify on a quarterly basis.

SOUTHERN UNION COMPANY
ONE PEI CENTER
WILKES-BARRE, PA 18711

November 21, 2003

Re: <u>PCAOB Rulemaking Docket Matter No. 008</u>

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

Dear Secretary:

This letter is in comment to PCAOB Rulemaking Docket Matter No. 008 (the "Proposed Standard") concerning the proposed auditing standard on an audit of internal control over financial reporting performed in conjunction with an audit of financial statements.

Section 404(a) of the Sarbanes-Oxley Act of 2002 (the "Act") requires that public company management annually assess and report on the effectiveness of the company's internal control over financial reporting. Section 404(b) of the Act requires registered public accounting firms to attest to, and report on, the assessment made by management. In an attestation engagement, auditors issue an examination, a review, or an agreed-upon procedures report on subject matter, or on an assertion about the subject matter, which is the responsibility of another party. Statements on Standards for Attestation Engagements No. 10 ("SSAE No. 10") identify certain engagements, such as a financial statement audit, that are not subject to the attestation standards.

The Proposed Standard mentions that the auditor's attestation of management's assessment of the effectiveness of internal control over financial reporting should be referred to as the "audit of internal control over financial reporting" as a financial statement audit is a form of attestation. This appears to contradict SSAE No. 10. The Act mandated that public accounting firms attest to management's assessment of internal controls over financial reporting. However, the Proposed Standard recommends an audit of internal control over financial reporting. The differences between an attestation engagement and an audit engagement differ significantly as to procedures, hours (both by management and public accounting firms) and cost. Despite the Proposed Standard's exceptional value in defining what an effective internal control environment over financial reporting should be, proposing an audit rather than an attestation will add extensive process and costs without adding corresponding value to shareholders. Please consider reducing the scope of the Proposed Standard from a detailed audit to an attestation/review of management's assertions, while maintaining the overall objective for public companies to have effective internal controls over financial reporting.

The Proposed Standard also significantly limits the reliance of internal audit's work by public accounting firms. Such limitations will increase management's time and cost for reporting on the effectiveness of internal control over financial reporting. If public accounting firms are allowed to rely on work done by internal audit in a financial statement audit, it does not seem appropriate to exclusively require external auditors to perform certain testing of internal controls (i.e., such as the walkthroughs themselves). As with any work performed by internal audit in a financial statement audit, some level of review or sub testing would be performed by the external auditors on the internal auditor's work. As such, the Proposed Standard fails to recognize the value and competencies that an internal audit department provides to a company and management. The internal audit function should be considered one of the primary tools for maintaining and monitoring internal controls and, the external auditors should be allowed to utilize the assistance of internal audit throughout the external auditors engagement in attesting to management's assessment of internal controls over financial reporting.

In the Securities and Exchange Commission's ("SEC") open meeting on May 27, 2003, the SEC indicated that the effective date of the Section 404 compliance was extended in part to: (i) give public company management and their auditors time to gear up for the new requirements and (ii) to give the PCAOB additional time to develop its rules on the independent auditor's attestation report on management's assertions on the adequacy of internal control over financial reporting, and to consider whether additional standards or guidance are appropriate. However, those rules are not yet finalized. Our Company, Southern Union Company, has a fiscal year end of June 30th. The Proposed Standard has required the company to reassess the adequacy and deficiencies in it's current internal control documentation performed to date. When the final rules are issued this could require the company to make additional changes. Additionally, the company's external accountants cannot currently address certain questions concerning their testing of internal control over financial reporting concerning such items as sample sizes, how to define materiality, what is considered adequate documentation, etc. The external auditors have been able to provide us responses based on their interpretation of current proposed rules, but have mentioned that definite firm guidance will not be available until the rules are finalized.

Southern Union is concerned that the lack of final rules to date concerning internal controls over financial reporting may hinder the ability to adequately document, test, correct and allow for external auditor testing over such controls by June 30, 2004. It has been six months since the SEC allowed an extension of the effective date of Section 404 due to the various reasons previously mentioned, which have not been resolved to date. In order to give companies sufficient time to comply with the final rules of Section 404 of the Act, they should be given nine to twelve months from the date of the final rules until effective management reporting over internal controls is required. This would give management adequate time to implement the final rules so to correct current documentation, to retest controls as required and to give management's external auditors time to review and test changes. Additionally, companies' external auditors will need to develop firm policies and guidelines, communicate requirements to clients and require sufficient time in order to test controls identified as occurring only quarterly. The PCAOB should encourage the SEC to extend the effective date of Section 404 for at least another three months, assuming that the final rules are released within the next 30 to 60 days. Southern Union agrees that company management should annually assess and report on the effectiveness of the company's internal control over financial reporting and allow registered public accounting firms to attest to, and report on, the assessment made by management. We raise the following question: Without final guidance for both company management with June 30 year-ends and their external auditors, is adequate time being allowed to comply with Section 404 of the Act?

Under the previously mentioned Proposed Standard, the following questions were asked in which I would like to respond to:

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?

   Response: No. I would suggest "the attestation review of management's annual assessment of internal control over financial reporting." In an attestation (or "attest" as used in the Act), the emphasis and focus on documenting and testing the system of internal controls over financial reporting should be on management of the company only. The auditor should then reperform some of management's test on a sample basis to obtain sufficient evidence that controls are operating as documented by management. An attestation review places the primary burden and cost of assessing the system of internal controls on management and not both management and their external auditor.

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?

   Response: The knowledge gained in the financial statement audit should improve the nature of the auditor's attestation review of management's annual assessment of internal control over financial reporting. Additionally, it appears that Section 404(b) of the Act intended that the external auditor should be prohibited from performing an attestation of internal control over financial reporting without also performing an audit of the financial statements. Section 404(b) states that "each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer…Any such attestation shall not be the subject of a separate engagement."

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?

   Response: This would be an appropriate alternative. Please also see the response to question number 2.

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?

   Response: No. No specific guidance or quantification is provided to define small and medium-sized issuers. Such measurements could include revenues, market capitalization, total assets, or number of employees involved in the financial aspect of internal controls. Additionally, consideration should be given to how internal control is implemented and conducted at companies that are highly regulated such as utilities, interstate pipelines and banks, which are subject to periodic audit, review and inspection of their financial information by regulators.

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.

   Response: The level of competence and training of the external audit personnel that is necessary to perform the attestation procedures over internal controls over financial reporting should be specified in the Proposed Standard. It appears that external audit firms have swung back and forth over time concerning the level of documentation and testing of internal controls that have been performed in financial statement audits, which brings into question the level of experience and competency that external audit staff have with respect to assessing the effectiveness of internal controls. External audit members at all levels should only be assigned tasks for which they are sufficiently competent.

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?

   Response: The Proposed Standard concerning the auditor's attestation of management's assessment of the effectiveness of internal control over financial reporting currently recommends that such engagement be referred to as the "audit of internal control over financial reporting." The Act as

enacted by Congress utilized the wording of "*attest to*, and report on, the assessment made by the management of the issuer." Consideration should be given to the original intent concerning the auditor's attestation of management's assessment of the effectiveness of internal control over financial reporting of the Act as an attestation and not an audit, while maintaining the overall objective for public companies to have effective internal controls over financial reporting.

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

   Response: It is appropriate for the Board to provide criteria that auditors should use to evaluate the adequacy of management's documentation, but additional guidance is necessary. Guidance should consider such items as the size of the company, nature of the company's operations, complexity of the system of internal control, management involvement in the operations of the business, quality of company employees, etc. Not all types of documentation involved in maintaining internal controls at companies are equally important. If adequate documentation is considered important in the determination of internal control evaluation, the lack of documentation would be costly and time consuming to remediate in order to ensure timely compliance with Section 404 of the Act. General references to "lack of documentation" are subject to many interpretations and therefore it is imperative that such criteria are specific and interpreted consistently. Additionally, excessive documentation "just for the sake of having documentation" could be expensive and provide both management and shareholders little to no value.

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?

   Response: I would answer no to both of these questions. Documentation will vary by company considering, among other things, the size of the company, the complexity of the systems and the experience of company employees documenting the systems. Unless you have the same external auditors review the documentation of each entity, what may be inadequate documentation for one accounting firm may not be inadequate to another. No standard or guidelines are provided as to what is adequate considering the numerous factors that may be present within a company that determines the extent of their documentation. As currently considered, measuring the adequacy of the documentation is too subjective. It is possible to have a strong system of internal controls over financial reporting but not have adequate or appropriate written documentation. Please also see the response to question number 7.

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

   Response: Yes. Walkthroughs allow an individual to obtain an understanding of the various financial processes and helps an individual to identify key control aspects of a process.

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?

    Response: No. If auditors can rely on work done by internal audit, management and others in a financial statement audit, it does not seem appropriate to exclusively require auditors to perform the walkthroughs themselves. As with any work performed by internal audit in a financial statement audit, some level of review or sub testing would have to be performed by the external auditors on any others work done in this area.

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?

    Response: It should be appropriate in certain instances to allow the external auditor to utilize portions of their evidence of the effectiveness of controls obtained in previous years. Once the effectiveness of a control has been tested, the external auditor should be allowed in future years to determine if circumstances surrounding this control have changed, and than to determine the level and extent of testing on such control for that year. For example, if certain information technology application controls were tested and deemed to be effective in the preceding year and appropriate controls are in place over the application development and maintenance function, a review of the particular application's controls in the current year should be limited to those application controls impacted by programming changes, if any.

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

    Response: Please see the response to questions number 10 and 14. The external auditors should be allowed to utilize the assistance of internal audit throughout the external auditors engagement in attesting to management's assessment of internal controls over financial reporting, as long as any work performed by internal audit is reviewed or retested on a sample basis by the external auditors.

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

    Response: The three categories of controls as presented in the Proposed Standard are appropriately defined. The Proposed Standard though mentions that no reliance should be placed on the work of others for controls such as those specifically intended to prevent or detect fraud. As previously mentioned, the external auditors should be allowed to utilize the assistance of internal audit for this category of controls as well as the other 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?

    Response: No. There is not enough recognition in the Proposed Standard of the value and competencies that an internal audit department provides to a company and management. The internal audit function should be considered one of the primary tools for maintaining and monitoring internal controls. The external auditors should be allowed to utilize the assistance of internal audit throughout the external auditors engagement in attesting to management's assessment of internal controls over financial reporting.

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)?

    Response: Allowing flexibility in determining the extent of reperformance of the work of others seems appropriate. The amount and nature of work reperformed by the external auditor should vary considering such items as the nature of the control, the number of transactions, the risk associated with the account and the quality of the documentation.

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?

    Response: Yes, if the term "principle evidence" is interpreted to mean that the external auditor may rely on the work of management and others after they have obtained adequate comfort that their work is sufficient and may be relied upon. If the term "principle evidence" means that the external auditor must reperform a majority of the sample of tests of controls performed by management and others, the response to this question would be no. Further clarification should be provided as to the meaning of "principle evidence."

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?

    Response: No. The Proposed Standard utilizes vague and open ended phrases such as "more than a remote likelihood" and "inconsequential in amount" and "by itself or in combination." These phrases could be subject to numerous interpretations depending on the reader. Additionally, the Proposed Standard mentions that a misstatement could be less than material (i.e., immaterial) but may still be highlighted because it is more than inconsequential. As currently written, many of these terms are confusing and should be rewritten to be more meaningful, definitive and straightforward.

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?

    Response: The examples in Appendix D provide helpful guidance but the examples do not provide a numerical quantification of materiality. Materiality is defined but not quantified in each example and the examples are constructed so that each situation clearly falls into one category or another. The examples do not address the quantitative determination of materiality for a particular transaction or balance. It would be helpful for the Board to provide guidance regarding quantitative materiality.

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

    Response: It is necessary for the external auditor to evaluate the severity of all identified control deficiencies so to determine if it is a significant deficiency, a material weakness or just a deficiency.

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?

    Response: No. Only material weaknesses and significant deficiencies should be communicated to management in writing. All other deficiencies or recommendations for improvements in internal controls should be allowed to be communicated to management either verbally or in writing.

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

    Response: No. The first two and last two bullets in paragraph 126 of the Proposed Standard could be strong indicators of material control weakness.

However, a weak audit committee, internal audit function, or regulatory compliance function does not necessarily indicate that a material weakness in internal control exists. It is possible that certain companies may have strong internal controls over financial reporting in spite of a weak audit committee, internal audit function, or regulatory compliance function.

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?

    Response: No. The Proposed Standard requires external auditor evaluation of the effectiveness of the audit committee that is too subjective and could create a conflict of interest. The majority of the recommended evaluation factors concerning the audit committee can only be performed through inquiry. How can an external auditor attest to: (i) the independence of the audit committee members from management, (ii) what the audit committee understands about its responsibilities, or (iii) the level of the audit committee's interaction with internal audit, unless the external auditor physically spent significant time with each audit committee member during the year?

    External auditors were just recently criticized in the not too distant past for their relationships with company management who previously approved the auditor's fees. Many individuals viewed this practice as an inherent conflict of interest. Under the current rules issued by the SEC, audit committees are now responsible for approving the auditors as well as their engagement fees. Requiring auditors to separately evaluate the effectiveness of the audit committee could reintroduce the same conflict of interest scenario that the current SEC rules were meant to eliminate.

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

    Response: No. Please see the response to question number 22.

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?

    Response: No. Audit committee effectiveness is a very subjective area, and any guidance or requirements issued in this area should be reconsidered. Please see the response to question number 22. Additionally, even if an external auditor was able to attest that the audit committee oversight was ineffective, this should have no bearing as to the effectiveness of the internal controls over financial reporting as the audit committee has no involvement

in the daily financial reporting of the company and the design and monitoring of internal controls over financial reporting.

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?

    Response: Yes, only if the material weakness in such control could impact the financial statements and no other compensating controls are present over such process. It would also be helpful to discuss in the Proposed Standard the extent to which companies can correct controls that have been identified as significant deficiencies in order to prevent an adverse opinion.

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

    Response: Yes. For example a small entity or department in a company may have a material weakness as it relates to the segregation of duties of a certain control aspect, but the cost of additional employees may not offset the potential financial statement impact of an error occurring as a result of the lack of segregation of duties.

27. Do you agree with the position that when the auditor issues a nonstandard 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?

    Response: Yes. This reporting would be the most informative and least confusing.

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

    Response: Yes. It would be helpful to know what activities the Board believes could or could not be performed by external auditors. Without specific guidance the companies' primary external auditors may be hesitant to provide certain services to companies or may provide services that they should not be providing.

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

    Response: Should external auditors be allowed to help in documenting client's internal controls or can the external auditors provide guidance on the internal control assessment process that management utilizes?

30. Are the auditor's differing levels of responsibility as they relate to management's quarterly certifications versus the annual (fourth quarter) certification, appropriate?

    Response: No. Section 404 of the Act states that "The Commission shall prescribe rules requiring each *annual* report…to contain an internal control report…" Based on this it appears that the intent of the Act was to cover the annual management assessment of internal controls by external auditors and to not require the external auditors to perform limited procedures on management's quarterly reports over internal controls over financial reporting as recommended by the Proposed Standard.

    Additionally, there could be instances during the year in which the company may install a new application and once it is operating with actual data and transactions, a material weakness (a programming "bug") could be identified by management that was not identified in the initial design of the application. If management corrects such "bugs" before the end of the year, the auditor should only be required to attest to the effectiveness of the current control, or the control present as of year-end. If the control is effective, management is allowed to conclude that internal controls over financial reporting are effective as of the end of a Company's fiscal year end.

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

    Response: Please see the response to question number 30.

Sincerely,

Jon A. Graf
Vice President and Controller
Southern Union Company

State of Wisconsin Investment Board

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November 21, 2003

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington DC 20006-2803

Re: **PCAOB Rulemaking Docket Matter No. 008 on Internal Control Audits**

Dear Board Members and Staff:

This comment letter on the Proposed Auditing Standard for Audits of Internal Control is submitted at the invitation of the Board for comments from interested parties.

The State of Wisconsin Investment Board (SWIB) is investment manager for the Wisconsin Retirement System, which provides retirement benefits for over 500,000 public employees in our state and is the 10th largest public pension fund in the US. We currently manage over $63 billion, with approximately 72 percent of those assets invested in the US. As a large investor, SWIB relies on the integrity and effectiveness of the audits of US public companies. We applaud efforts of the PCAOB to identify the shortcomings of current auditing standards and to strengthen the auditing process.

In addition to conveying general support for the proposed standards, I would like to draw your attention to the following comments, which are numbered to correspond to questions posed in PCAOB Release No. 2003-017:

2. We concur that the objectives and work involved in performing an attestation of management's assessment of internal control and an audit of the company's financial statements are closely interrelated. SWIB supports the proposed requirement that an audit firm be prohibited from conducting an audit of internal control without also auditing the financial statement. I believe this is also consistent with the requirements of s. 404 (b) of the Sarbanes-Oxley Act, which provides that internal control attestations "not be the subject of a separate engagement."

4. One size does not fit all when considering requirements for public companies in different circumstances. While SWIB generally believes that it is preferable to expend additional company resources on improved audits in order to reduce investor losses to negligence, fraud and litigation costs, we think it is also appropriate to consider the burdens that extensive regulations would have on smaller companies that do not have complex, multi-national operations. SWIB supports standards that impose different audit test requirements in accordance with a reasonable cost-benefit analysis associated with a company's size and complexity.

5. It seems obvious that more complicated or critical audit tasks should be performed by audit firm personnel that have a greater level of experience or training. SWIB supports a requirement that

senior management interviews about possible fraud, and other high-level audit tasks, be performed by seasoned auditors.

6. SWIB supports a requirement that auditors be required to both evaluate management's process for determining that its control standards are effective and testing to gather evidence about effectiveness of those controls. This goes to the heart of the independent audit process. Failure to require both an independent evaluation and testing to confirm systems operation would leave investors susceptible to the same kinds of audit failures that have plagued the US markets over the last two years.

10. In order to obtain an independent judgment on significant internal control processes, SWIB believes it is appropriate to require auditors to perform their own walkthroughs of accounting and information systems and financial report preparation processes. We would not consider an audit to be "independent" if it were based on assurances of these important internal control processes made only by company management or internal auditors.

22. Recent corporate governance reforms in the Sarbanes-Oxley Act underscored importance of the role of the audit committee, giving it new powers and responsibilities. Existence of a competent and strong audit committee is one of the central pillars upon which the current system of corporate governance and financial reporting stands. SWIB supports creation of a requirement that auditors evaluate effectiveness of the audit committee's oversight of financial reporting and internal controls.

28. In order to implement new SEC rules on auditor independence, SWIB suggests that the PCAOB consider providing further guidance to auditors on what consulting engagements are likely to present an unacceptable conflict, where an auditor might end up auditing its own work. In addition, investors would take comfort from a requirement that, along with obtaining audit committee approval for consulting assignments, the auditor be required to certify to investors (pursuant to Sections 201 and 202 of the Sarbanes-Oxley Act) that it has made its own independent finding that the consulting duties will not impair the auditor's independence.

SWIB acknowledges that the PCAOB is also receiving comments from audit practitioners on details of the proposal. We profess no particular audit expertise and submit these comments from the point of view of an investor. However, we hope our observations will be of help to the PCAOB in its deliberations on producing a final rule that is fair and balanced.

Fee free to contact me if SWIB can be of further assistance.

Sincerely,

Keith Johnson
Chief Legal Counsel

cc: Investment Board Members
Executive Director

Robert C. Salipante
President
Sun Life Financial U.S.

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November 21, 2003

VIA E-MAIL

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 2006-2803

Re: PCAOB Rulemaking Docket Matter No. 008

Dear Sir/Madam:

Sun Life Financial Inc. appreciates the opportunity to submit written comments to the Public Company Accounting Oversight Board (the "Board") regarding PCAOB Release No. 2003-017, Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements (the "proposed standard"). We have focused our comments on four of the Board's questions, namely, Questions 17, 18, 22 and 23. We will address Questions 17 and 18 together, and Questions 22 and 23 together.

Question 17.

Will the definitions in the proposed standard of significant deficiency and material weakness provide for increased consistency in the evaluation of deficiencies? How can the definitions be improved?

Question 18.

Do the examples in Appendix D of how to apply these definitions in various scenarios provide helpful guidance? Are there other specific examples that commentators could suggest that would provide further interpretive help?

Response to Questions 17 & 18.

We do not believe that the Board's proposed definition of "significant deficiency" will provide for increased consistency in the evaluation of deficiencies. Under the Board's proposed definition at page A-9 of 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." (underlining added). The phrase "more than inconsequential in amount' is ambiguous and the examples provided at Exhibit D of the Release do not provide any helpful interpretive guidance as to the meaning of that phrase. We believe that the Board's use of the phrase "more than inconsequential in amount" is likely to result in differing assessments being made in similar factual situations by practitioners. We also believe that the phrase "more than inconsequential in amount" is fundamentally inconsistent with well-established accounting, auditing and attestation standards premised on the concepts of fair presentation, materiality and reasonable assurance.

We also note that the Board's proposed definitions of "significant deficiency" and "material weakness" are different than the definitions used by the Securities and Exchange Commission (the "SEC") in its Release No. 33-8238 pursuant to Section 404 of the Sarbanes-Oxley Act of 2002 (the "Act"). In Release No. 33-8238, the SEC stated that the term "material weakness" has the same meaning as in the definition under GAAS and attestation standards, and that the term "significant deficiency" has the same meaning as the term "reportable condition" as used in AU § 325 and AT § 501. The Board's and the SEC's use of different definitions of "material weakness" and "significant deficiency" is confusing. Should management use the SEC's definitions or the Board's definitions? In our view, management is required to follow SEC guidance when complying with its obligations under Sections 404 and 302 of the Act and SEC rules promulgated thereunder, while the auditor will be required to follow the Board's definitions. How will management and the auditor reconcile the definitional differences?

Further, we believe that the following language in the Board's proposed standard as it relates to the definition of "significant deficiency" will promote inconsistency in the evaluation of deficiencies. At page 15 of the proposed standard, the Board states: "[u]nder the proposed auditing standard, an internal control deficiency (or a combination of internal control deficiencies) should be classified as a *significant deficiency* if, by itself or in combination with other internal control deficiencies, it results in more than a remote likelihood of a misstatement of the company's annual or interim financial statements that is more than inconsequential in amount will not be prevented or detected." (underlining added). As noted above, however, the Board defines "significant deficiency" at page A-9 of the proposed standard as follows: "[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." (underlining added). At page A-2 of the proposed standard, the Board states: "[t]he standards use the word 'should' to indicate obligations that are presumptively mandatory. . . . The Board uses the words 'may,' 'might,' 'could,' or other terms and phrases to describe actions and procedures that the auditor has a professional obligation to consider." We anticipate confusion among practitioners by the Board's use of the words "could" and "should" in different places in the proposed standard in relation to an auditor's obligation to classify an internal control deficiency as a "significant deficiency."

In view of the foregoing, we urge the Board to adopt the same definitions of "significant deficiency" and "material weakness" as recognized in SEC Release No. 33-8238. By doing so, the Board would promote consistency with SEC guidance and well-established auditing and attestation standards concerning internal control over financial reporting.

Question 22.

Is it appropriate to require the auditors to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting?

Question 23.

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

Response to Questions 22 & 23.

We do not believe that it is appropriate for the auditors to evaluate the effectiveness of the audit committee in light of the purposes of Section 301 of Act, nor do we believe that auditors could effectively carry out this responsibility. Pursuant to Section 301 of the Act, Congress made the audit committee directly responsible for the appointment, compensation, and oversight of the auditor. In its Release No. 33-8220 pursuant to Section 301 of the Act, the SEC stated as follows:

> One of the audit committee's primary functions is to enhance the independence of the audit function, thereby furthering the objectivity of financial reporting. The Commission has long recognized the importance of an auditor's independence in the audit process. The auditing process may be compromised when a company's outside auditors view their main responsibility as serving the company's management rather than its full board of directors or its audit committee. This may occur if the auditor views management as its employer with hiring, firing and compensatory powers. Under these conditions, the auditor may not have the appropriate incentive to raise concerns and conduct an objective review. Further, if the auditor does not appear independent to the public, then investor confidence is undermined and one purpose of the audit is frustrated. One way to help promote auditor independence, then, is for the auditor to be hired, evaluated and, if necessary, terminated by the audit committee. This would help to align the auditor's interests with those of shareholders.

We are unable to reconcile this SEC commentary with the requirement in the Board's proposed standard that the auditor evaluate the effectiveness of the audit committee. Just as the auditor was perceived to be beholden to management before passage of the Act, the auditor will now be perceived to be beholden to its new employer, the audit committee, and will not be expected to raise concerns and conduct an objective review of audit committee effectiveness. As a result, auditor independence will once again be called into question and public confidence in auditing work will be undermined. We believe that this is exactly the type of apparent – if not actual – conflict of interest that Congress was attempting to eradicate when it passed Section 301 of the Act.

To further public confidence in the integrity of financial statement and internal control audits, we urge the Board to abandon any requirement that the auditor evaluate the effectiveness of the audit committee.

We appreciate the opportunity to express our views and I would be pleased to discuss our comments or answer any questions that you may have. Please do not hesitate to contact me regarding our submission.

Very truly yours,

/s/ Robert C. Salipante

Robert C. Salipante
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Sun Life Financial U.S.

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November 20, 2003

Public Company Accounting Oversight Board Via email to comments@pcaobus.org
Office of the Secretary
1666 K Street, N.W.
Washington, DC 20006-2803

Re: PCABO Rulemaking Docket No. 008 - Comment letter on Proposed Auditing Standard *An Audit of Internal Control Over Financial Reporting Performed In Conjunction With An Audit Of Financial Statements*

I am writing to express my opinions regarding the above referenced Proposed Auditing Standard. My responses are numbered to correspond to certain of the questions raised by the Board in the Proposed Standard.

- Question No. 1: The decision as to whether to call the auditor's report (i) an audit of internal control over financial reporting vs. (ii) an audit of management's assessment of the effectiveness of internal control over financial reporting should be based upon the scope of work required of the auditor. The scope of the Proposed Standard requires the auditor to perform procedures that are fairly characterized as an audit of internal control over financial reporting. The auditor would not be required to perform as extensive procedures if they were issuing a report on management's assessment of the effectiveness of internal control over financial reporting. Since both the Sarbanes-Oxley Act and SEC Release No. 33-8238 only require the later, I believe the Board should either (i) reduce the scope of the procedures required of the auditor, who would issue an attestation report on management's assessment of the effectiveness of internal control over financial reporting or (ii) set forth the reasons it believes that the more extensive (and expensive) audit of internal control over financial reporting is appropriate.
- Question No. 4: I do not believe the Proposed Standard gives appropriate consideration as to how internal control is implemented. Paragraph 15 addresses the inherent limitations in any system of internal control over financial reporting. Paragraph 16 addresses the *reasonable assurance* aspect of any system of internal control over financial reporting. Yet both of these concepts do not appear to be adequately addressed in the definitions of *internal control deficiency, significant deficiency or material weakness* contained in Paragraphs 7 - 9. The Proposed Standard should be clarified in this regard.
- Questions No. 9 and 10: The auditor should be allowed to use their professional judgment to determine whether or not walkthroughs are an appropriate procedures to perform, and whether they need to be performed by the auditor themselves or whether they can be performed by others (e.g. internal auditors).

- Questions No. 12 - 15: The auditor should be allowed to use their professional judgment to determine the nature and extent to which the auditor can use the work of management or others, including internal auditors, and the nature and extent to which the auditor will test the work of others. Detailed rules are not required.
- Questions No. 22 - 24: Due to the inherent conflict of interest, the auditor should not be required to evaluate the effectiveness of the audit committee to whom the auditor directly reports, insofar as it relates to the auditor's reporting on internal control over financial reporting. As an alternative, it may be appropriate for the auditor to subjectively evaluate the audit committee, along with other pertinent factors, before deciding whether or not to accept the engagement.

Thank you for your consideration of these comments and suggestions.

Best regards,

Greg Swalwell

SVIR ASAI ASRI SIIA
SVIR Schweizerischer Verband für Interne Revision
ASAI Association suisse d'audit interne
ASRI Associazione svizzera di revisione interna
SIIA Swiss Institute of Internal Auditing

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

Zurich, November 19th, 2003

Re: PCAOB Rulemaking Docket Matter No. 008
Duplication of work performed by management and others and external auditor in compliance with Sarbanes-Oxley Act under the Proposed Auditing Standard

Dear Madam,
Dear Sir,

Thank you for the opportunity to comment on the proposed auditing standard on an audit of internal control over financial reporting performed in conjunction with an audit of financial statements.

As a result of the Sarbanes-Oxley Act, the SEC requires management to evaluate the effectiveness of internal control over financial reporting. In addition, management needs to make an assessment of the effectiveness of internal control over financial reporting. For most issuers this is a new task that results in a considerable additional effort because they used to delegate this task to their external auditor. The main reason was that companies thought the external auditor covered most of internal control over financial reporting during his audit of the financial statements and reported on it in his management letter.

Under the Sarbanes-Oxley Act, the external auditor is required to attest to and report on the assessment made by the management. Management cannot delegate its responsibility to assess its internal control over financial reporting to the external auditor. This wording by Congress and the SEC already implies that the external auditor evaluates and uses the work of management and *others*. For this purpose, *others* could mean internal auditor or any other third parties under the direction of the management.

The sections of the proposed auditing standard, which concern the use of the work of management and others, appear to be a deviation from the flexible risk based audit approach. The new fixed categories of controls where the external auditor should not use the results of testing performed by management and others or where the external auditor's use should be limited are not consistent with a risk based and cost efficient audit approach. In addition, we believe the principle, that the auditor must obtain *directly* the "principle evidence" about the effectiveness of internal control over financial reporting in order to form an auditor opinion, is too inflexible.

In the proposed auditing standard, the external auditor is required to assess and satisfy himself that the persons who have performed the testing of controls are competent and objective before he may use the results of their work. If the management, internal auditor or a third parties who are deemed to be competent and objective by the external auditor, he should be allowed to use the work performed by these persons such as documented walkthroughs, work related to company-wide anti-fraud programs and controls, and work related to other controls that have a pervasive effect on the company. Of course, we agree that the external auditor retains the responsibility in deciding his sample size for testing of controls either by re-performing some tests done by the management and others or by performing tests on controls that are not included in the sample selected by management and others.

In conclusion, fixed categories of control do not offer an appropriate flexibility in determining the extent of the use of work performed by management and others. We believe that the extent of the use of others' work should be determined by a risk assessment of inherent risk and control risk. Of course, we agree that the external auditor retains the final responsibility for his opinion and the extent of the use of others' work. Due to the magnitude of the overlap, we urge the Board to examine this issue seriously.

If you have any questions or would like to discuss any of my comments further, you can contact me by phone 01141 1 249 27 77 or by e-mail at hpfyffer@kpmg.com.

Yours sincerely

Hans-Ulrich Pfyffer
President

From: Malcolm Schwartz [malcolm@crsassociatesllc.com]
Sent: Tuesday, November 25, 2003 9:27 AM
To: Comments
Subject: PCAOB Rulemaking Docket Matter No. 008

Dear PCAOB:

I apologize for these comments being after the 5:00 PM (EST) November 21, 2003, cutoff. So, if you wish to ignore them, you are certainly entitled to do so.

But, as a one of the listed principal authors of The COSO Report, which you cite and which framework you follow to a great extent, and as a consultant practitioner who has applied and refined The COSO Framework over the past twelve years while working with clients who wished voluntarily to apply the Framework, either to prevent, or respond to, problems with internal control, I just wanted to voice some concerns with the proposed auditing standard.

My concerns derive from my seeing the ways that some firms, including some major audit firms, are incorrectly advising their clients in regard to Sarbanes - Oxley compliance; and my fear that the proposed standard might fail to correct some of this incorrect advice.

One major problem is that some firms have confused the COSO illustrative tools with the COSO Framework, and hence have failed to focus sufficiently on all five components of the Framework, and the major control breakdowns regarding such exposures as fraud, collusion, management override and intentionally misleading information. Your proposed standard clearly identifies the five components of control that comprise the COSO Framework, but your proposed standard then goes into substantial detail on transaction controls, with less attention and balance to fraud, collusion, management override and intentionally misleading. Furthermore, I have seen clients negatively impacted by situations that would pass the examples of controls testing (for example, in the case of vouchering, as well as in the case of shipping
documentation) that you provide in your proposed standard.

Another problem is related to the preceding observation. It is that some firms providing advice are treating fraud as a separate process, for example, and not as a condition that results from being able to overcome weak controls in basic business processes. Too many of the tools being applied go into great detail regarding transaction-related controls, and on the other hand treat fraud through a review of simple checklists. I have found that this approach can be improved, and integrated, through treating all five controls components and their associated internal controls as effected through both management and business processes.

As a management consulting partner at PricewaterhouseCoopers (and Coopers & Lybrand before that) prior to my retirement, I spent some time, after the COSO Report was issued, in developing tools for both my consulting teams and the auditors to use in regard to controls assessments, and also trained audit staff in regard to analyzing processes. I generally found that auditors were more comfortable with checklists than with process analysis, and this bias might inhibit their abilities to apply the kind of walkthroughs and tests that are described in your proposed standard. It will be important, therefore, for auditors to be well-trained in these new approaches, to have the need for judgment be limited as audit firms gain leverage through the use of younger and less-experienced staff, and to give attention to auditing the auditors.

I understand why you have combined in one standard the testing of financial statements and the testing of internal controls over financial reporting, but I fear that this will lead to overly focusing on detailed transaction controls, related to substantive testing and to traditional checklists, as opposed to testing related to the major exposures that are the primary concern of Sarbanes - Oxley. This overly detailed orientation is what I am finding in the work of some firms providing advice to clients regarding the documentation and testing required for Sarbanes - Oxley compliance. I simply suggest that your standard reinforce, if it can, the distinctions between the testing of financial statements, and the testing of business and management processes related to all five components -- the integrated framework -- of the COSO Framework, for internal controls over financial reporting.

If you do read this even though it is past the cutoff, and if it is of any interest to you to pursue any of these concerns, I will be happy to share with you some of the relevant tools and approaches that I have developed over the years since I helped to create The COSO Report. I have built this experience into the approach that I am helping to develop for supporting clients in regard to Sarbanes - Oxley compliance for Technology Solutions Company, a systems integrator consulting company, and I am getting good reaction to our approach from knowledgeable industry parties.

Malcolm Schwartz
Senior Vice President, Technology Solutions Company
And
COO, CRS Associates LLC

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From: Read, Joseph S. [joseph.read@teldta.com]
Sent: Friday, November 21, 2003 5:00 PM
To: Comments

Evaluating the Effectiveness of the Audit Committee Oversight:

It does not make sense that 404 would ask the external auditors to evaluate the effectiveness of the group that is responsible for hiring, firing, and evaluating the effectiveness of the external auditors. This appears to be a clear case of a conflict of interest. Except in worse case scenarios, how can we expect external auditors to perform this function with any independence?

Defining Significant Deficiency and Material Weakness:

The standard does attempt to define the risk categorization, however, more detail is required to allow for a consistent application of the standard. The external audit guidance provided to our company has resulted in an extremely low threshold when pressed to put numbers around the quantitative factors defining the terms remote likelihood, inconsequential in amount, and material misstatement. The 5% (remote likelihood), 1% (inconsequential in amount), and 3% (material misstatement), respectively, apply a threshold that is not only difficult to assess across a test of controls, but if strictly applied would make doing business impossible.

Definition of a Qualified Opinion:

The standard again sets a low threshold requiring a qualified opinion on an item that has the potential to cause a material misstatement, but can be proven to have not resulted in a misstatement.

Example of a Significant Deficiency:

Our organization in the last year has spent significant time discussing, and coming to agreement, with our external auditors the application of specific accounting principals, only to be over ruled by their "national office". This change in application has resulted in material amounts within our financial statements being re-classified (prior to issuance). Would this be classified as a deficiency for applying the principal incorrectly?

A material misstatement that is discovered prior to issuance and discussed with the external auditor is again a low threshold. Especially when the external auditor is involved in the process for vetting the period-end findings and issues.

Joe Read

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Texas Instruments Incorporated

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November 21, 2003

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1666 K Street, N.W.
Washington, D.C. 20006-2803

Via E-Mail: comments@pcaobus.org

Re: Invitation to Comment on PCAOB Rulemaking Docket Matter No. 008

Ladies and Gentlemen:

Texas Instruments Incorporated (TI) welcomes the opportunity to comment on the proposed auditing standard, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*. It is evident that the PCAOB and its staff have carefully considered the current auditing standards on internal control and have sought to improve these standards. While we concur with the majority of guidance in the proposed standard, I offer comments on behalf of TI for your consideration in the areas of reliance on the work of others and external auditor evaluation of the audit committee.

Reliance on the work of others

Having spent over 10 years as an auditor at a Big Four firm, I encountered a wide variety of control environments at my clients and I understand the need for an appropriate balance between the work of the external auditor and the internal auditor. Based on my experience, I believe that the provisions of the proposed standard concerning the reliance of the external auditor on the work of others are overly restrictive and will result in unnecessary duplication of effort.

I agree that the external auditor should consider the factors outlined in paragraph 103 of the proposed standard to determine the level of reliance upon the work of management and others. However, I am concerned about the requirement in paragraph 104 that precludes the external auditor from relying upon the work of the internal auditor for the testing of information technology general controls and walkthroughs.

While I acknowledge that the quality of internal audit departments varies by company, the external auditor should be able to determine the extent of reliance upon the work of internal audit similar to the process defined in AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*. If the internal audit department is staffed with audit professionals experienced with testing controls, it would be appropriate for the external auditor to utilize the work of these professionals to the greatest possible extent.

At TI, we have an experienced group of information system internal auditors who have extensive experience with the company's customized systems and their related controls. This group has historically coordinated its workplan for information system control testing with the external auditor to ensure that the scope of testing is appropriate for external audit reliance. The external auditors perform a detailed review of the internal audit workpapers and then reperform certain tests as required by current auditing standards. The proposed standard states that the external auditor should perform the control testing of "certain types of information technology controls." It is my understanding that external auditing firms have interpreted this statement to indicate that the external auditor should perform the testing of general computer controls. Since many general computer controls are routine and are not subject to interpretation (security, passwords, hardware and software development, business interruption, etc.), it seems as though general computer controls could be tested by the internal auditor in the same manner as the other routine controls mentioned in the proposed standard.

The significant financial statement frauds in recent history have generally occurred at the management level and I believe that the requirement for the external auditor to test general computer controls would not have prevented such frauds. As noted in the proposed standard, I agree that it is appropriate for the external auditor to focus on high risk areas. At some companies, general controls might be considered a high risk area that deserves focused attention by the external auditor; however, the risk assessment related to these controls should be the decision of the external auditor. To require testing of general computer controls by the external auditor would not recognize the routine nature of many of these controls and the low risk surrounding general controls at companies like TI.

I also believe that the external auditor should be able to rely upon walkthroughs performed by the internal auditor. Again, a risk assessment should form the basis of the external auditor's determination as to which walkthroughs could be performed by the internal auditor. I agree with the PCAOB that important evidence about internal control can be obtained through a properly performed walkthrough. I do not advocate that walkthroughs should be performed by company personnel who do not have experience in auditing and inquiry procedures, but do believe that the internal auditor is certainly qualified to perform such procedures, particularly in low risk areas. The external auditor would gain sufficient evidence of control functioning through a combination of the control procedures he or she performs in addition to walkthroughs, a review of the internal auditor's walkthrough workpapers, and reperformance and follow up inquiry.

I urge the PCAOB to reconsider the use of qualified internal audit departments for testing of general computer controls and walkthroughs. At TI, we take the requirements of Sarbanes-Oxley and the PCAOB very seriously and have spent a significant effort in both cost and manpower to comply with these requirements. By restricting the use of internal audit, there will be a

significant overlap of work and duplication of effort by the internal and external auditor. This is disruptive to the operation of our business and does not ultimately benefit our shareholders.

<u>External audit evaluation of the audit committee</u>

It is not appropriate for the external auditor to evaluate the effectiveness of the audit committee. The Sarbanes-Oxley Act gave the audit committee the authority to engage and compensate the independent auditor. To require formal evaluation of the audit committee by the external auditor would reintroduce the conflict of interest that Sarbanes-Oxley sought to eliminate.

At TI, we strongly believe that the audit committee is critical to setting a proper "tone at the top." Our audit committee has procedures for performing an ongoing evaluation of our external auditor and maintains an open dialogue with the external auditor concerning TI's control environment and significant accounting policies and practices. Our external auditor also provides feedback to the audit committee as appropriate concerning audit committee best practices. We believe that this relationship best serves the interests of both parties and fosters open communication.

The external auditor should continue to consider audit committee functioning and oversight as part of its risk assessment process and evaluation of the control environment, but to require a formal report would be a conflict of interest. If the PCAOB deems it necessary to have a formal evaluation of the audit committee, it would be more appropriate to have this evaluation performed on a periodic basis by a party other than the external auditor.

*****

We appreciate the opportunity to comment on the Proposed Standard and would be pleased to discuss our comments with you in further detail.

Sincerely,

Melanie L. Merrion

Melanie L. Merrion
Accounting Research Manager
Texas Instruments Incorporated
(214) 480-2341
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Texas Society of
Certified Public Accountants

November 21, 2003

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

RE: PCAOB Release No. 2003-017 – Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction With An Audit of Financial Statements.

To Whom it May Concern:

One of the expressed goals of the Texas Society of Certified Public Accountants (TSCPA) is to speak on behalf of its membership when such action is in the best interest of its members and serves the cause of certified public accountants in Texas, as well as the public interest. TSCPA has established the Professional Standards Committee to represent those interests on accounting and auditing issues. This communication is in accordance with that goal.

Our response to this Proposed Auditing Standard includes our answers to the questions posed in the document along with additional comments on issues we considered critical to the final draft of this Standard.

Our Committee believes this Standard will have a significant impact on the audit landscape. We believe there will be a need for auditors to adjust their approach to an audit engagement in light of the requirement to attest to the effectiveness of internal control. This Standard will certainly impact the evidence gathering process and techniques currently used in performing an audit engagement. We believe this Standard will dramatically increase the cost of an audit engagement as well as the time needed to complete the audit process. This Standard will mark the beginning of the "dual standards" for the performance of audit engagements. We believe the PCAOB should be cognizant of the potential for the "cascade effect" of its Standards on the audits of nonpublic companies. Such an event could have a devastating effect on nonpublic companies and many of the firms that perform their audits.

Comments on Questions Regarding the Proposed Standard

Question 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?

TSCPA Response: We do not believe it would be appropriate to refer to the auditor's attestation of management's assessment of the effectiveness of internal control as the audit of internal control over financial reporting. An audit, by definition, implies an

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examination of underlying data. Unless an auditor performs audit tests, he/she cannot indicate that an audit was performed. An auditor's attestation of management's assessment of the effectiveness of internal control does not, in our opinion, constitute an audit. Additionally, management is not required to perform tests to determine the effectiveness of internal control. Management is only required to provide an assessment. Management can use any number of techniques to make the assessment, and testing may or may not be among them.

Question 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?

TSCPA Response: We do not believe an auditor should be prohibited from performing an audit of internal control without performing an audit of the financial statements. In the unlikely event that there is a concern over the objectivity of the auditor performing both the financial statement audit and the audit of internal control, then there should be two separate auditors. Certainly, from an efficiency and effectiveness point of view, having the same auditor (audit firm) conduct both audits would be preferable. However, we don't think it would be prudent to require that both audits could only be performed by the same auditor.

Question 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?

TSCPA Response: We believe requiring the auditor to perform work with regard to the financial statements *comparable* to that required to complete the financial statement audit to be a requirement that appears to narrowly dictate the scope of the audit of internal control. Also, isn't "the performance of work *comparable* to that required to complete the financial statement audit," essentially auditing the financial statements? We obviously don't see this as an appropriate alternative.

Question 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 companies?

TSCPA Response: We believe this Standard is aimed at the large publicly traded companies where internal controls can be implemented in a more cost-effective manner than is possible in small and medium-sized companies. The requirements of this standard impose a substantial cost impact on small and medium-sized companies. Recent reports in the financial press regarding relatively small public companies being taken private as a result of the requirements of the Sarbanes-Oxley Act indicate a significant concern about the cost of compliance.

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Page Three

Question 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.

TSCPA Response: There is no question that the Board should specify the level of competence and training of the audit personnel that is necessary to perform auditing procedures effectively. Lack of experience on the part of audit staff personnel is one of the primary factors cited in many of the recent audit failures. These personnel are performing a significant amount of the audit work without effective supervision. We believe internal control represents one of the most subjective aspects of a client's accounting system. To allow the responsibility for the assessment of internal control to be put primarily in the hands of inexperience personnel seems contrary to the intent of the Proposed Standard. The Board should definitely specify the level of experience necessary to be a part of the audit team evaluating the client's assertion about the effectiveness of its internal control.

Question 6: Is the scope of the audit appropriate in that it requires the auditor to both evaluate management's assessment and obtain, directly, evidence about whether internal control over financial reporting is effective?

TSCPA Response: We believe the scope of the audit is appropriate assuming that the auditor performing the audit of the financial statements also performs the internal control audit. If the auditor performing the audit of the financial statements is different from the auditor performing the internal control audit, then issues related to the scope of the audit of internal control should be addressed in the Standard. However, as mentioned earlier, we do not believe the scope of the internal control audit should include "work *comparable* to that required to complete the financial statement audit."

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

TSCPA Response: We believe the Board should provide criteria that auditors can use in evaluating the adequacy of management's documentation. An auditor needs to be provided with guidelines that he/she can use in assessing management's documentation. Without such guidelines the audits of internal control performed by public accounting firms would lack comparability and users would be uncertain as to the basis for the auditor's conclusions.

Question 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?

TSCPA Response: Given the fact that documentation is a necessary part of management's assessment of internal control effectiveness, we believe inadequate documentation of internal control would constitute an internal control deficiency. However, we do not necessarily believe that inadequate documentation of internal control should automatically be considered a significant deficiency or material weakness in internal control. The auditor should be cautioned in the Standard to consider whether such inadequate documentation may indicate a significant deficiency or material weakness in internal control.

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

TSCPA Response: We believe walkthroughs enhance the auditor's level of understanding and should be required. However, it should be pointed out in the Standard that walkthroughs are a necessary, but not sufficient, condition for an auditor's understanding of internal control. An auditor should be required to perform whatever tests/procedures he/she considers necessary in the circumstances.

Question 10: Is it appropriate to require that the walkthrough be performed by the auditor himself or herself, rather than allowing the auditor to use walkthrough procedures performed by management, internal auditors, or others?

TSCPA Response: In addition to our belief that a walkthrough should be required, we feel the walkthrough should be conducted by the external auditor. However, this should not preclude the external auditor from placing reliance on the work performed by an internal audit staff in situations where he/she has determined that the client has a strong, effective internal audit function. The criteria established for assessing the effectiveness of the internal audit function in SAS 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, should be used.

Question 11: Is it appropriate to require the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year or may the auditor use some of the audit evidence obtained in previous years to support his or her current opinion on management's assessment?

TSCPA Response: We believe it would be appropriate to require the auditor to obtain evidence of the effectiveness of internal controls for all relevant assertions for all significant accounts and disclosures every year if problems continue to exist in the effectiveness of the client's internal controls. However, in situations where the auditor's testing showed strong, effective internal controls, the auditor should not be required to perform tests on an annual basis. Thus, we believe that annual testing should only be required if the auditor encounters problems in his walkthrough and general assessment of internal controls. Additionally, yearly testing might be required in situations where the auditor considers the risk of material misstatement due to fraud to be high.

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

TSCPA Response: In our opinion, the extent to which the auditor should be allowed to use the work of management and others should be limited to the work performed by the internal audit staff. This, of course, assumes that the auditor has determined through assessment of the internal audit function that its work is competent and objective (SAS 65).

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

TSCPA Response: The three categories appear to be appropriately defined.

Question 14: Does the proposed standard give appropriate recognition to the work of internal auditors? If not, does the proposed standard place too much emphasis and preference on the work of internal auditors or not enough?

TSCPA Response: We believe that the Proposed Standard is lacking in its recognition of the work of internal auditors. A competent and objectively placed internal audit function can provide the external auditor with a great deal of assistance in accomplishing the objectives of this Standard. If reliance is based on an assessment of the competence and objectivity of the internal audit function (SAS 65) the external auditor should have a strong basis for placing reliance on the work of the internal auditor.

Question 15: Is the flexibility in determining the extent of reperformance of the work of others appropriate, or should the auditor be specifically required to reperform a certain level of work (for example, reperform tests of all significant accounts or reperform every test performed by others that the auditor intends to use)?

TSCPA Response: An auditor should be required to reperform the work of others that he/she plans to rely upon until the auditor feels that the work being performed by others meets an appropriate level of quality and reliability. Subsequent to the decision to rely on the work of others, the auditor should exercise professional judgment in determining when subsequent reperformance of such others' work should again be considered.

Question 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?

TSCPA Response: An auditor's comfort and reliability level concerning a client's internal control should grow over time. Initially, it would appear that the auditor should have to obtain the principle evidence, on an overall basis, through his/her own work. The auditor should always be required to perform some first hand analysis of internal control. Thus, the Standard should not imply that the auditor can ever rely solely on the work of others in reporting on management's assertion about internal control effectiveness.

Question 17: Will the definitions in the proposed standard of significant deficiency and material weakness provide for increased consistency in the evaluation of deficiencies? How can the definitions be improved?

TSCPA Response: We believe the definitions appear to be adequate at this time. However, we suggest that the Board closely monitor this area of practice and changes in business environments in an effort to maintain the relevance of the definitions of significant deficiencies and material weaknesses.

Question 18: Do the examples in Appendix D of how to apply these definitions in various scenarios provide helpful guidance? Are there other specific examples that commenters could suggest that would provide further interpretive help?

TSCPA Response: The examples in Appendix D provide helpful guidance. We are reluctant to provide any additional examples due to the new ground that this Standard covers. However, we believe that once the Standard is implemented and practitioners are involved in the process, a number of specific questions will be raised. At that time the development of more timely and relevant guidance will be possible.

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

TSCPA Response: We believe that the evaluation of the severity of all identified deficiencies should be required. Without an evaluation of the severity of all deficiencies, an auditor might not adequately assess a deficiency that could permit a material misstatement to occur.

Question 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?

TSCPA Response: It is important that auditors be required to communicate, in writing, all internal control deficiencies to management. Such communication is necessary in assisting the client in deciding whether the deficiency is of a nature that corrective action should be taken.

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

TSCPA Response: We believe the matters are appropriately classified.

Question 22: Is it appropriate to require the auditors to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting?

TSCPA Response: We believe the external auditor is appropriately placed to provide an evaluation of the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting. The fact that the audit committee is responsible for the appointment of the external auditor may be seen by some as a deterrent to an objective assessment by the auditor. However, we believe an ineffective audit committee could cause significant problems with which an auditor would not want to be associated.

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

TSCPA Response: We fully believe an auditor should be able to effectively carry out his/her responsibility to evaluate the effectiveness of the audit committee's oversight responsibility. An auditor's inability to make this evaluation would most likely be caused by a limitation of the auditor's scope by the client. This kind of action would most likely indicate to the auditor that there is a problem with the oversight function.

Question 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?

TSCPA Response: Guidance should be provided to an auditor concerning when he/she should give serious consideration to withdrawing from an engagement. It would be quite difficult to provide examples of every scenario that would require the auditor to withdraw from an engagement. There are so many variables that could be involved in such a situation that we believe ultimate withdrawal should be left to the auditor's professional judgment.

Question 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?

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

TSCPA Response to Questions 25 and 26: We do not believe the existence of a material weakness, by itself, should require the expression of an adverse opinion. We do believe that such a circumstance should, as a minimum, result in a qualified "except for" opinion. The issuance of an adverse opinion should be left to the judgment of the auditor. Setting a requirement that an adverse opinion must be issued when a material weakness exists, results in treating all material weaknesses the same. We believe that material weaknesses can vary in degree of the significance regarding a particular entity's internal control. Thus, the auditor should be able to assess the impact of the material weakness on the client in deciding on the type of opinion to issue.

Question 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?

TSCPA Response: When an auditor issues a non-standard opinion on the effectiveness of an entity's internal control, the reasons for the departure should be stated in an explanatory paragraph(s) in the report.

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

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

TSCPA Response to Questions 28 and 29: We fully believe the Board should provide specific guidance on independence and internal control-related non-audit services in the context of the Proposed Standard. While it might appear appropriate to prohibit the financial statement/internal control auditor from providing internal control-related non-audit services, we believe that such a requirement would be counterproductive. The auditor who performs the internal control audit is in the best position to know where the deficiencies are and what needs to be done to correct those deficiencies. Therefore, we believe it would not be an impairment of the auditor's independence for him/her to provide consulting services to the client so that the client's internal control can be brought into compliance with the requirements of this Standard.

Question 30: Are the auditor's differing levels of responsibility as they relate to management's quarterly certifications versus the annual (fourth quarter) certification, appropriate?

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

TSCPA Response to Questions 30 and 31: We find no problems with the differing levels of responsibility regarding certification or the auditor's responsibility for quarterly disclosures.

Thank you very much for allowing us the opportunity to present these comments in accordance with the goals stated above.

Sincerely,

Jeff Gregg

C. Jeff Gregg, CPA
Chair, Professional Standards Committee
Texas Society of Certified Public Accountants

From: J.D. Higginbotham [jd@tivo.com]
Sent: Monday, October 20, 2003 6:11 PM
To: Comments
Subject: Proposed Auditing Standards

Dear Sirs;

I am writing to express concern over the apparent confusion resulting from the following comments in the recent Proposed Auditing Standard (Oct 7, 2003):

"The proposed auditing standard ... would allow the auditor to incorporate into the audit ... some of the work performed by others, such as internal auditors or third parties ...The proposed auditing standard also would require that, overall, the auditor obtain directly the "principal evidence" about the effectiveness of internal control over financial reporting."

One might understand that this paragraph indicates that the PCAOB expects the auditor to conduct their own work to obtain the "principal evidence" for their opinion and that the only work performed by internal auditors and third parties that may be incorporated into the audit would be for other than "principal evidence."

What throws particular confusion into the mix is the preceding paragraph in the proposed standard:

"Thus, the more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be."

I was happy to believe that the PCAOB was actually considering the exorbitant costs now required in complying with all the new Sarbanes-Oxley regulations. I wanted to believe that if we, management, did our job of documenting and testing our internal controls well, that we could reduce the final costs we must bear with regards to the required attestation by external auditors.

However, I was dismayed after reading a recent Alert from our external auditors, KPMG, that completely omitted the reference to reduced costs (KPMG Defining Issues No. 03-22). They focused instead on "the proposed standard does say that, on an overall basis, KPMG's own work would have to provide the principal evidence for their opinion." I was taken by surprise upon reading this claim and went back to the Proposed Auditing Standard to see how they could interpret such a position.

After reviewing the paragraph quoted above, I now understand how there could be confusion as to the intent of the PCAOB. I believe it would be helpful to clarify this point and would suggest that the final wording would allow companies to fulfill the intent of Sarbanes-Oxley with the least expense possible. At the end of the day, while most investors want to know they can rely on the financial statements of public companies, they also want to invest in companies that are increasing the value of their investment rather than spending more to comply with regulations.

David Higginbotham
Assistant Controller and
Chairman, Sarbanes-Oxley Compliance Committee
TiVo Inc.

From: Jonathan Trevathan [jonathan@cityofdetroit.com]
Sent: Tuesday, November 18, 2003 6:25 PM
To: Comments
Subject: PCAOB Rulemaking Docket Matter No. 008

Hello,

With regards to the section of the proposal on walkthroughs, I agree that a walkthrough is a valuable tool in gaining an understanding of an organizations control structure. The way the briefing paper is currently worded though, I think may be unrealistic, or should at least be more specific. Currently, the paper states:

"In a walkthrough, the auditor traces all types of company transactions and events - both those that are routine and recurring and those that are unusual - from origination, through the company's accounting and information systems and financial report preparation processes, to their being reported in the company's financial statements."

The way this is worded, it sounds as though the auditor should take a specific customer order, for example, and trace it from the time the order comes in the door (or over the phone, etc.) through shipment to the customer, creation of the invoice, and receipt and application of cash. It is often difficult to gather and see all of these events for a single transaction, in the limited amount of time an auditor is at the client.

It seems it would be more reasonable to break a process into separate units, each of which a walkthrough could be performed for. Though in an ideal world the walkthrough would be of one transaction, I think it would prove very difficult in many business environments.

Perhaps this was assumed, but it does not seem clear given the current wording of the paper. Could you update that part please?

Thank you,

Jonathan Trevathan

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19 November 2003

Office of the Secretary
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1666 K Street, N.W.
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USA

Via E-Mail: comments@pcaobus.org

Re: PCAOB Rulemaking Docket Matter No. 008

Dear PCAOB Members:

The Sarbanes-Oxley Section 404 ("SOX 404") requirements on internal control over financial reporting are a key initiative in the effort to restore investor confidence and to ensure integrity in financial reporting. As an SEC registrant, UBS welcomes the opportunity to provide comments on the PCAOB proposed auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements,* (the "Proposed Standard"). The following letter will provide some general comments followed by specific responses to some of the questions on which the PCAOB seeks feedback.

General Comments

As you may be aware, UBS is the world's leading provider of wealth management services, one of the largest asset managers globally, and among the major global investment banking and securities houses. Although it is headquartered in Zurich, UBS is listed on the NYSE and has nearly 40% of its workforce (over 25,000 individuals) located in the U.S. UBS is committed to meeting the leading corporate governance standards worldwide and will comply with SOX 404 for its 2005 financial reports.

UBS believes that it is important that foreign registrants (and particularly financial institutions) have a recognized voice in the comment process related to Sarbanes-Oxley requirements because of the different perspectives (and often different legal requirements) under which such companies operate.
UBS strongly supports the Sarbanes-Oxley legislation and the associated rules that have been developed as they are helping create a level playing field for corporate governance standards globally. In addition, UBS sees a strong connection between SOX 404 requirements and the qualitative aspects of the operational risk requirements within the Basel Accord reform proposals.

Indeed, UBS has combined its efforts to comply with these two regulatory requirements under a broader operational risk management framework and therefore values alignment of these requirements to the extent possible. UBS appreciates the recognition the PCAOB and SEC have provided to the linkage between SOX 404 and the FDICIA process and hopes that the Basel Committee will recognize the linkages between their own efforts on operational risk and SOX 404.

In general, UBS supports the general framework outlined by the Proposed Standard as it will ensure that auditors contribute to the development of sound internal controls over financial reporting. In particular, UBS believes that the approach of requiring a link from financial statement assertions and preventive/detective controls to financial accounts provides an appropriate basis for ensuring that a company's internal controls have been appropriately designed and are operating effectively. The following will provide specific comments in response to the PCAOB questions.

Specific Comments

<u>Question 6</u>: *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?*

UBS agrees with the PCAOB's proposed scope for the audit because it believes that this will be the only way in which the spirit and intent of SOX 404 can be met. A simple audit of the management assessment process, and not the controls themselves, would be insufficient as it would emphasize form over substance. UBS notes here that the proposed scope appears to go further than what is typically required in other current auditing standards on internal controls (e.g., SAS 70 in the U.S. and FRAG 21/94 in England and Wales).

Therefore, UBS believes it would be helpful for the PCAOB to note explicitly the relationship of the Proposed Standard to SAS 70 to ensure that it is clearly recognized that the Proposed Standard imposes a stronger requirement (i.e., by requiring the auditor to not only evaluate whether management has met its stated control goals but also whether those goals are effective enough to ensure effective internal control over financial reporting) than a SAS 70 certification. This will help ensure clarity between different internal control audit processes and ensure that the SOX 404 audit does lead to greater confidence in financial reporting.

<u>Question 5</u>: *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, would it be inappropriate for a new, inexperienced auditor to have primary responsibility for conducting interviews of a company's senior management about possible fraud.*

<u>Question 7</u>: *Is it appropriate that the Board has provided criteria that auditors should use to evaluate the adequacy of management's documentation?*

UBS sees a linkage between these two questions in that they are related to the ability of auditors to form an independent judgment on the internal management documentation and testing. UBS believes it is appropriate for Proposed Standard paragraph 43 to provide suggested criteria that auditors should look for from management in planning their audit. However, UBS notes that these suggestions need to be considered carefully and clearly labeled as examples only in order to ensure that they do not become a mandatory list of items that auditors require of companies. As such, UBS appreciates the statement in Proposed Standard paragraph 44 that “no one form of documentation is required.” UBS believes that this concept should be emphasized even further.

Within the list contained in paragraph 43, UBS has some concerns about the suggestion for documentation of “information about how significant transactions are initiated, recorded, processed, and reported” and “enough information about the flow of transactions to identify where material misstatements due to error or fraud could occur.” In particular, UBS is concerned that these suggestions may lead to an auditor expectation for management to have process or transaction flowcharts available for review.

In order to ensure effective internal control, UBS believes that management should identify the key control related responsibilities of the functions that make up the organization. Implicit in this is an understanding of key process flows. However, documented process analysis is less important than having clearly identified and documented functional roles and responsibilities, key control objectives, and related control standards that ensure the objectives are met. While flowcharts may be useful training devices in certain cases, they are not necessary tools for ensuring internal control. In addition, flowcharts also may quickly become outdated as processes adapt to changing organizational or market circumstances. Thus, a requirement by auditors for companies to maintain flowcharts merely for the purposes of their audit would be unduly burdensome.

UBS notes by way of contrast that Proposed Standard paragraph 69 would require the auditors themselves to identify significant processes and to “understand the flow of transactions, including how transactions are initiated, recorded, processed, and reported” and to “identify the points within the process where a misstatement – including a misstatement due to fraud – related to each relevant financial statement assertion could arise.” UBS believes that this is an appropriate expectation to place on auditors as they must be able to understand where the key control points are in a process. However, auditors should not necessarily expect management to maintain detailed flowcharts (as might occur given the current drafting of paragraph 43) to assist in this.

This is where UBS sees a connection with PCAOB Question 5. UBS believes that auditors engaged in the SOX 404 audits should be required to be sufficiently experienced in the industry that they are auditing to have an understanding not only of the processes of the company that they are auditing but also where the key control points are likely to be located within those processes. This will ensure that the SOX 404 audit, which is expected to be burdensome enough, is as efficient as possible. It will also ensure that auditors are focused on evaluating the effectiveness of the controls themselves and not the efficiency of the processes within which the controls are embedded. An emphasis on flowcharts could result in a focus on documentation of what currently exists as opposed to what controls should exist in order to ensure effective internal control.

<u>Question 9</u>: Are the objectives to be achieved by performing walkthroughs sufficient to require the performance of walkthroughs?

<u>Question 10</u>: 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?

Proposed Standard paragraph 48 states that auditors should obtain an understanding of the design of controls via procedures that may include inquiry, inspection, observation, and tracing transactions. In addition, Proposed Standard paragraph 74 states that auditors should obtain evidence of the effectiveness of controls either by performing tests or by using the work of others. However, Proposed Standard paragraphs 79 and 104 both state that walkthroughs should be a mandatory procedure for auditors both as part of the effort to understand and test both the design and operating effectiveness of controls.

UBS does not object to a requirement for walkthroughs per se, but does believe that the currently proposed walkthrough requirements may be overly burdensome and misdirected. Under Proposed Standard paragraph 80, an auditor would be required to conduct a walkthrough that encompasses "the entire process of initiating, recording, processing, and reporting individual transactions, and controls for all five internal control components and fraud, not just control activities." UBS believes that a walkthrough that examines every link in a process chain is more than what is actually necessary to evaluate internal control. In addition, UBS also believes that such a walkthrough may focus on the efficiency of the process and thereby might lose sight of the internal control aspects, which should be the primary focus for SOX 404.

Given this, UBS appreciates the statements in proposed paragraph 79 that the walkthrough should be intended to provide the auditor with evidence to "confirm the auditor's understanding of the design of controls", to "evaluate the effectiveness of the design of controls" and to "confirm whether controls have been placed in operation." However, UBS does not believe that paragraph 79 (and by implication the related statements in paragraphs 80-83) should state that the walkthrough is intended to provide the auditor with evidence to "confirm the auditor's understanding of the process flow of transactions" and to "confirm that the auditor's understanding of the process is complete."

As noted in its comments on Questions 5 and 7, UBS believes that the auditors performing the SOX 404 audits should be sufficiently experienced to understand the process flows within the company that they are auditing without detailed flowcharts or walkthrough procedures. Instead, the SOX 404 audit should focus solely on an evaluation of the key control points that must be designed and operating effectively to ensure the reliability of financial reporting.

<u>Question 11</u>: 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?

UBS does not believe that auditors should be required to obtain evidence of the effectiveness of controls over all significant accounts and disclosures via relevant financial statement assertions on a yearly basis. All controls, accounts, and disclosures will not necessarily change on a yearly basis. Thus, there may be many cases where a full re-audit would be redundant. In addition, the requirement for a full audit each year would preclude the adoption of a risk-based audit approach.

UBS also has concern with two proposed aspects of the auditor requirements for evaluating operating effectiveness. First, Proposed Standard paragraph 88 states that an auditor should not only evaluate whether the control is operating as designed but also "whether the person performing the control possesses the necessary authority and qualifications to perform the control effectively." UBS is concerned that this is a highly subjective evaluation that could be interpreted as a requirement for a company to justify the qualifications of its staff. UBS does not believe that this is necessarily the intention of the PCAOB and suggests that this merely be clarified.

Second, UBS notes that Proposed Standard paragraph 102 makes a distinction between manual and automatic controls with respect to auditor testing. In particular, the Proposed Standard states that "manual controls should be subjected to more extensive testing than automated controls" and that "the more frequently a manual control operates, the more operations of the control the auditor should test." UBS does not believe that these distinctions are meaningful or useful. When evaluating internal controls, management and auditors should be concerned with whether the control objectives were met. Whether this is done through a manually applied or an automatically applied control is not relevant to the determination of whether the control is operating effectively. The extensiveness and frequency of testing should be determined by the nature of the control itself (i.e., how important it is to meeting the objective) and not the form of the control. UBS believes that the proposed distinctions between manual and automatic controls would only result in additional burdens (from the need to distinguish those controls that are manually applied from those that are automatically applied) without substantial additional benefits.

<u>Question 12</u>: *To what extent should the auditor be permitted or required to use the work of management and others?*

<u>Question 13</u>: *Are the three categories of controls and the extent to which the auditor may rely on the work of others appropriately defined?*

UBS agrees with the goal of the PCAOB to draft the Proposed Standard in such a way that auditors are provided with flexibility in using the work of others while at the same time preventing inappropriate reliance on the work of others. This requires a fine balancing of interests and a clear specification of guidelines for when auditors should and should not rely on the work of others. In general, UBS agrees with the concept of having three categories of controls (i.e., those where the auditor cannot rely on the work of others when performing the evaluation; those where reliance should be limited because they pose a high risk due to judgmental decisions; and those where reliance is not limited in any manner).

UBS believes that the list of items where reliance is prohibited in Proposed Standard paragraph 104 may be too broad in the following two areas:

- Controls that are part of the control environment, including controls specifically established to prevent and detect fraud that is reasonably likely to result in material misstatement of the financial statements
- Walkthroughs, as discussed beginning at paragraph 74.

With respect to the first item, it may be appropriate to ask auditors to separately evaluate the general control environment separately from management. However, this is an area where it is often difficult to perform specific "tests" of controls as many of the controls relate to corporate culture and other intangible aspects of a company. UBS also is not clear about the significance of the separation of the fraud concerns both in this paragraph and in other paragraphs in the Proposed Standard (e.g., 24-26, 43, 53, 69) when these are part of the Control Environment component of internal control frameworks such as COSO. UBS strongly believes that segregation of duties and the development of key control objectives is part of the process of addressing the risk of fraud. An attempt to separate fraud prevention as another activity appears artificial. Of course, material misstatements that could arise from fraud must be addressed. However, the identification of fraud controls in several paragraphs of the Proposed Standard may lead to the assumption that a separate control process is necessary specifically for fraud issues.

With respect to walkthroughs, please see the comments on Questions 9 and 10.

UBS also notes that Proposed Standard paragraph 53 defines a new term "company level controls" to include the following items:

- Control environment, including tone at the top, the assignment of authority and responsibility, consistent policies and procedures, and company-wide programs, such as codes of conduct and fraud prevention, that apply to all locations and business units.
- Management's risk assessment process.
- Centralized processing and controls, including shared service environments.
- Monitoring results of operations.
- Monitoring of controls, including activities of the internal audit function, the audit committee, and self-assessment programs.
- The period-end financial reporting process.
- Board-approved policies that address significant business control and risk management practices

Proposed Standard paragraph 54 then suggests that auditors may wish to test and evaluate these controls first while paragraph 55 states that this testing is not sufficient for opining on the effectiveness of a company's internal control. UBS does not object to this definition and believes it is generally aligned with the term "entity level controls" that has been used by a number of auditors. In general, when following the COSO or other internal control frameworks, it is sensible to start with a comprehensive evaluation of the internal controls. UBS merely seeks clarification around the use of the terms "company level controls" and "entity level controls" and the limitations imposed under paragraph 104.

<u>Question 14</u>: 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?

UBS sees a clear need to give appropriate recognition to the work done by internal audit and other internal independent control functions regarding assessment of the effectiveness of the design of the control framework and its operation. A global financial institution of the size of UBS has a high number of significant processes across many legal entities and geographical locations that impact the significant accounts and disclosures. A validation of these activities is achieved through a large number of control activities carefully located in the front-to-back process chain. Internal audit is particularly well suited to ensure the integrity and the overall effectiveness of the processes and the reliability of the financial information flow.

UBS has an internal audit function that is fully independent, has unrestricted audit rights, and reports significant results to the Board of Directors and the Audit Committee. The head of internal audit reports to the Chairman of the Board of Directors and has regular meetings with the Audit Committee. The methodologies and the quality of work of internal audit are assessed by the Audit Committee and by external auditors and regulators (e.g. UK FSA, FED).

UBS agrees with the concept of having three categories of controls that differentiate the extent to which the external auditors may rely on the work of others when evaluating internal control in any individual instance. UBS also uses different categories for the definition of the internal review processes (e.g., the highest level requires an assessment by a control function independent of the business which is the owner of the control). The internal audits conducted over time are risk-based and include an assessment of the overall design of the control framework in the audited area, its documentation and its effective operation.

The recognition of the work performed by internal audit and other internal independent control functions would not only provide clear benefits from an efficiency point of view, but also increase the overall effectiveness of the evaluation of the internal controls in the front-to-back processes across geographical locations. While UBS understands the rationale for imposing high standards on the external auditor to obtain independently an unbiased opinion, UBS believes that the work performed by its internal audit function - highly independent from business management - reflects to a high degree the aims of the walkthroughs described in paragraph 79 through 83. Therefore, the recognition of the testing performed by internal audit should be better reflected in the relevant sections of the Proposed Standard where reference is made to the use of the work performed by management and others (including internal audit).

Question 17: Will the definitions in the proposed standard of significant deficiency and material weakness provide for increased consistency in the evaluation of deficiencies? How can the definitions be improved?

UBS appreciates the effort by the PCAOB to provide definitions of key terms such as deficiency, significant deficiency, and material weakness (Proposed Standard paragraphs 7-9 and Appendix D Examples D1-D3) and to provide guidance on significant locations and accounts (Proposed Standard Appendix B paragraphs B4-B19 and examples B1- B4) and materiality considerations (Proposed Standard paragraphs 21-23). UBS takes note of the fact that the participants at the PCAOB roundtable did not express concerns with the existing understanding regarding these definitions in the U.S. accounting profession.

However, UBS finds the proposed terms confusing and their use within the Proposed Standard difficult to reconcile. It is logical to distinguish between those control failures that pose only a slight risk of misstatement in the financial statements and therefore should be reported to a company's internal management and audit committee and those control failures that are deemed so material that they pose a severe risk of misstatement and therefore should be disclosed to investors and other third parties. It is unclear, however, why a simple materiality concept cannot be used to distinguish these two types of control failures and why there needs to be three levels of control failures plus additional guidance regarding materiality. UBS would prefer a simple materiality standard that is used to distinguish those control failures that merely indicate some questions regarding the financial statement reporting process from those control failures that call into question the reliability and validity of the financial reporting process.

No matter what definitions are adopted, UBS agrees that the guidance provided in Appendix B and D of the Proposed Standard are vital to understanding the concepts that should be applied. As far as UBS is aware, this is the first concrete examples of the appropriate scope and nature for the SOX 404 evaluations by management and/or auditors. Therefore, UBS believes that this guidance should be reviewed carefully as it will likely become the leading reference source for those seeking practical examples when designing SOX 404 compliance and auditing programs.

<u>Question 22</u>: 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?

UBS believes that the Proposed Standard should encourage companies to have strong internal audit functions. UBS believes that companies should be motivated to have internal audit functions that are well-staffed with qualified individuals that have demonstrable independence from management and who comply with best practice standards. For example, UBS has a clear separation between its Executive Board, which has management responsibilities, and its Board of Directors, which has oversight responsibilities. The independent internal audit function reports to the Board of Directors only. This has provided a sound structure for ensuring the quality of internal auditing practices. To the extent possible, the Proposed Standard should encourage companies to develop sound governance structures around internal audit functions as this will help strengthen the internal controls over financial reporting generally.

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UBS appreciates the opportunity to comment on the Proposed Standard. If you have any questions on the matters we have raised in this letter or would like to discuss any of them further, please contact:

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Yours sincerely,

UBS AG

Walter Stuerzinger	Hugo Schaub
Group Chief Risk Officer	Group Controller

November 21, 2003

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20066-2803

Attention: Mr. Thomas Ray, Deputy Chief Auditor

Re: PCAOB Rulemaking Docket Matter No. 008

Dear Sir:

As a public company and highly regulated banking institution, we would like to take this opportunity to comment on the PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements.*

We have reviewed the Proposed Auditing Standard, and while other industries who have not been exposed to the rigors of FDICIA may need to review these controls as proposed by PCAOB, banks with assets in excess of $500 million have been required to perform a review of internal control under the Federal Deposit Insurance Corporation Improvement Act of 1990. We believe this requirement is more than sufficient to ensure banking institutions have adequate internal control and management oversight, as well as a regulator (FDIC, State, or Federal) that ensures compliance. **Therefore, we strongly believe that banks with assets over $500 million and subject to FDICIA should be excluded from the Proposed Standard and allowed to continue to evaluate internal controls based on the requirements of the Federal Deposit Insurance Corporation.**

Thank you for your attention to this matter.

Very truly yours,

Thomas E. Hales
Chairman of the Board, President, and
Chief Executive Officer

TEH/dh
(Hales:Let\03)PCAOB Standard Rebuttal

GAO
Accountability * Integrity * Reliability

Comptroller General
of the United States

United States General Accounting Office
Washington, DC 20548

December 9, 2003

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Subject: *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*

This letter provides the U.S. General Accounting Office's (GAO) comments on the Public Company Accounting Oversight Board's (PCAOB) October 7, 2003, proposed standard for the audit of internal control over financial reporting performed in conjunction with the audit of financial statements.

We commend the PCAOB for giving this important issue high priority and on the release of the proposed auditing standard. Overall, we support the proposed standard and believe that it is on track. We especially support the requirements for

- obtaining direct evidence about the design and operating effectiveness of internal control as well as evaluating management's assessment; and
- requiring tests of controls for "relevant assertions" rather than "significant controls" in order to link the internal control engagement to the entity's financial reporting.

GAO strongly believes that management's assessment of the effectiveness of internal control, along with the auditor's attestation on that assessment, are critical components of monitoring the effectiveness of an organization's risk management and accountability systems. Auditors will better serve their clients and other financial statement users and will better protect the public interest by providing assurances about the effectiveness of internal control. In this regard, GAO seeks to lead by example in establishing an appropriate level of auditor reporting on internal control for federal agencies and programs, and for entities receiving significant amounts of federal funding. We already provide opinions on internal control for all our major federal audit clients, including the consolidated financial statements of the U.S. government.

Attached are GAO's responses to selected questions in PCAOB Release No 2003-017, along with our additional comments regarding the following:

- nonroutine transactions and processes,
- testing IT controls,
- materiality considerations,
- illustrative auditor's reports, and
- other clarifications.

We thank you for considering our comments on this very important issue.

Sincerely yours,

David M. Walker
Comptroller General
of the United States

Enclosures

cc: The Honorable William H. Donaldson, Chairman
Securities and Exchange Commission

The Honorable William J. McDonough, Chairman
Public Company Accounting Oversight Board

GAO'S RESPONSE TO SELECTED QUESTIONS IN PCAOB RELEASE NO. 2003-017 AND OTHER RELATED COMMENTS

Integrated audit of financial statements and internal control over financial reporting

Question 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?

We believe it is appropriate to refer to an auditor's attestation of management's assessment of the effectiveness of internal control over financial reporting as an "audit of **the effectiveness** of internal control over financial reporting." (We suggest adding "the effectiveness," as shown in bold.) As stated throughout the standard, the auditor will perform procedures and testing that go beyond evaluating management's assessment in order to determine whether management's assessment of the effectiveness of internal control is fairly stated. This will result in an audit of the effectiveness of internal controls, which we support.

Question 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?

Question 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?

We believe that it is most efficient for the audit of the effectiveness of internal control over financial reporting to be performed in conjunction with the financial statement audit. However, we believe that there should be flexibility should the auditor wish to perform this work apart from the financial statement audit, and we do not support a prohibition against doing so.

Audit of internal control over financial reporting

Question 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.

We agree with the criterion set forth in paragraph 31 of the proposed standard “that the auditor should have competence in the subject matter of internal control over financial reporting.” We also agree with the additional general guidance in the proposed standard such as the example cited in question 5, “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.” At the same time, we believe that any additional guidance added to the standard should avoid becoming overly prescriptive. An alternative would be for the Board to issue implementing guidance on this issue to supplement the standard if it further specified the level of competence and training.

Evaluation of management’s assessment

Question 6. Is the scope of the audit appropriate in that it requires the auditor to both evaluate management's assessment and obtain, directly, evidence about whether internal control over financial reporting is effective?

To provide an opinion on management’s assessment of the effectiveness of internal control, it is necessary for the auditor to both evaluate management’s assessment and obtain direct evidence about whether internal control is effective.

Question 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?

Inadequate documentation of management’s assessment, by itself, does not meet the definition of material weakness or significant deficiency. We agree with the guidance provided in paragraphs 43-47 of the proposed standard, that inadequate documentation is a deficiency that the auditor should evaluate to determine whether management can demonstrate adequate monitoring of internal control over financial reporting by other means.

Obtaining an understanding of internal control over financial reporting

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

We agree that performing walkthroughs can provide the auditor with helpful information about internal control design and operations. At the same time, we believe that walkthrough procedures are not always necessary or appropriate. For instance, performing walkthroughs of highly automated processes or certain unusual nonroutine transactions could be extremely difficult or even impossible. Therefore, we suggest that the Board encourage auditors to use such procedures for relevant assertions for all significant accounts and disclosures but, at the same time, allow auditors to use other means for obtaining an understanding of internal control and determining the nature and extent of testing where appropriate. When alternative procedures are used, those procedures should provide the auditor with a similar level of evidence as walkthrough procedures would provide for understanding internal control and determining the appropriate level of testing.

Question 10. Is it appropriate to require that the walkthrough be performed by the auditor himself or herself, rather than allowing the auditor to use walkthrough procedures performed by management, internal auditors, or others?

Under certain conditions it is appropriate for the auditor to use walkthrough procedures performed by internal auditors. Internal auditors can play an important role in concluding about the effectiveness of internal control. In some cases, the internal auditors may be assisting management with its assessment of internal control. In other cases, internal auditors may be testing controls and testing management's assessment. In either scenario, there are contributions that the internal auditor can make to the external auditor's understanding of internal control—including the results of procedures such as walkthroughs—as input to the auditor's determination of the nature and extent of testing to be conducted as part of the audit of internal control. However, the work of the internal auditor should not be used as the principal evidence, and the external auditor will need to determine the level of reliance to place on that work. Such a determination should be made on a case-by-case basis, based on facts, circumstances, and risk. We believe that the guidance in paragraph 108 for relying on the work of internal auditors is appropriate for making this determination.

If the auditor uses walkthrough procedures performed by management or a consultant hired by management, the auditor should test the walkthrough for validity and completeness, as the auditor would test any information provided by management.

Requirement for the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year

Question 11. Is it appropriate to require the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year or may the auditor use some of the audit evidence obtained in previous years to support his or her current opinion on management's assessment?

We support a requirement for the auditor to obtain evidence every year of the effectiveness of internal control for assertions for **material** accounts and disclosures **that present moderate or high risk,** as opposed to a requirement for the auditor to obtain evidence of the effectiveness for **all relevant** assertions for **all significant** accounts and disclosures every year.

We also believe that rotational testing of controls would be acceptable under the following conditions: (1) control risk is evaluated as low, the control environment is strong, and inherent and fraud risk factors are low, (2) the auditor possesses from past and current work a foundation of audit evidence on which to develop current audit conclusions; (3) financial reporting controls over all significant cycles or applications have been evaluated and tested during a fairly recent period (no more than 3 years); and (4) no specific reporting or risk issues preclude the use of rotation.

A requirement for evaluating the effectiveness of controls for all relevant assertions for **material** accounts and disclosures **presenting moderate or high risk** every year would not only guide the auditor in the audit of effectiveness of internal control, but would also contribute to the quality of the financial statement audit. This is a powerful means for linking the financial statement audit and the audit of the effectiveness of internal control and gaining synergy and overall improved audit quality.

<u>Extent of reliance on the work of management and others</u>

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

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

Question 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?

This section of the standard should be made more specific to indicate that this section does not deal with the auditor's reliance on the work of other external auditors. Our answers are based on the assumption that the board will provide separate guidance for relying on the work of another external auditor.

We agree with the concept of delineating controls and procedures for which it is not appropriate that the auditor rely on the work of management and consultants hired by management. We would suggest, however, that the terminology "use the work of others" be changed to "**rely** on the work of others." Certainly, the auditor would want to use any information or evidence provided by management or consultants hired by management about control problems. The key point is that the auditor would not **rely** on that work, but use it as part of the process of gaining an understanding of controls to determine the nature, timing, and extent of the auditor's tests.

We agree with the category of controls and with the degree of reliance set forth in paragraph 106; specifically, that the auditor might decide to use the results of tests performed by management and others within the company in areas such as controls over routine processing of significant accounts and disclosures without specific limitation.

We disagree, however, with the classification of controls and procedures listed in paragraphs 104 and 105. For instance, in paragraph 105, the proposed standard states that the auditor's use of the results of procedures performed by management and others should be limited for (1) controls over significant nonroutine and nonsystematic transactions, and (2) controls over significant accounts, processes, or disclosures where the auditor has assessed as high the risk of failure of the controls to operate effectively. We believe that these are significant controls and that the auditor should not rely on procedures performed by management or consultants hired by management for these controls. However, the auditor could, based on the auditor's assessment of the internal audit function in accordance with criteria set forth in paragraph 108, determine the appropriate reliance to place on the internal audit function for the controls and procedures listed in both paragraphs 104 and 105.

Finally, as stated in our answers to questions 9 and 10, we believe that the auditor could place some reliance on walkthrough procedures performed by internal auditors. If the auditor uses a walkthrough provided by management or another party (such as a consultant hired by management), the auditor should test the walkthrough for such factors as validity and completeness, as the auditor would in testing any information received by management.

Therefore, we suggest restructuring and rewording paragraphs 104 and 105 to read as follows:

> The following are controls for which the auditor should not **rely** on the results of testing performed **by management or by consultants hired by management**:
>
> - controls that are part of the control environment, including controls specifically established to prevent and detect fraud that is reasonably likely to result in material misstatement of the financial statements;
>
> - controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; to initiate, record, and process journal entries in the general ledger; and to record recurring and nonrecurring adjustments to the financial statements (for example, consolidating adjustments, report combinations, and reclassifications);

- 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;

- controls over significant nonroutine and nonsystematic transactions (such as accounts involving significant judgments and estimates); and

- controls over significant accounts, processes, or disclosures where the auditor has assessed as high the risk that the controls will fail to operate effectively.

In some cases, it may be appropriate for the auditor to place some reliance on work performed by the internal auditor related to the above controls. Based on risk and the auditor's assessment of the internal audit function in accordance with criteria in paragraph 108, the external auditor should determine the appropriate level of reliance to place on the internal audit function.

Question 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?

As we commented in our response to question 14, this section of the standard should be made more specific to indicate that it does not deal with the auditor's reliance on the work of other external auditors. Therefore, our answer to question 16 also is based on the assumption that the board will provide separate guidance for relying on the work of another external auditor.

We agree that requiring auditors overall to obtain the principal evidence through their own work (when relying on the work of internal auditors, management, or consultants hired by management) is an appropriate benchmark for the amount of work that is required to be performed by the auditor. We also agree with the criteria set forth in paragraph 103 for determining whether to use work performed by management and others. We further agree with the recognition given to the unique position of internal auditors in this process as set forth in paragraph 108.

Evaluating results

Question 17. Will the definitions in the proposed standard of significant deficiency and material weakness provide for increased consistency in the evaluation of deficiencies? How can the definitions be improved?

We support the revised definitions of significant deficiency and material weakness as set forth in paragraphs 8-9 of the proposed standard. The revised definitions are more specific and provide clearer guidance to the auditor than the previous definitions from AU section 325 and AT section 501.

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

Unless clearly inconsequential, the auditor should evaluate the severity of all identified internal control weaknesses in order to determine whether the deficiencies, individually or in combination, are significant deficiencies or material weaknesses.

Question 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?

With regard to communicating results that are not significant deficiencies, we recommend that the Board adopt requirements similar to *Government Audit Standards*, which state "When auditors detect deficiencies in internal control that are not reportable conditions, they should communicate those deficiencies separately in a management letter to officials of the audited entity unless the deficiencies are clearly inconsequential considering both quantitative and qualitative factors. Auditors should use their professional judgment in deciding whether or how to communicate to officials of the audited entity deficiencies in internal control that are clearly inconsequential. Auditors should include in their audit documentation evidence of all communications to officials of the audited entity about deficiencies in internal control found during the audit."[1]

Forming an opinion and reporting

Question 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?

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

We agree that it is only appropriate for the auditor to issue an unqualified opinion on internal control when there are no identified material weaknesses and when there have been no restrictions on the scope of the auditor's work.

When there is one or more material weaknesses, we believe that it is appropriate for the auditor to express an adverse or qualified opinion about the effectiveness of the company's internal control over financial reporting, depending on the facts and circumstances. In certain circumstances, qualified or "except for" reports could be

[1] *Government Auditing Standards* (GAO-03-673G, June 2003), paragraph 5.16.

appropriate for localized deficiencies, deficiencies involving one control cycle, or material weaknesses that are detected and corrected by management. Therefore, we do not support a requirement that would direct the auditor to issue an adverse opinion on internal control in the event of one or more material weaknesses. Instead, we believe the auditor would need to consider issuing an adverse opinion based on the facts and circumstances surrounding the weaknesses identified.

<u>Auditor independence</u>

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

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

We believe that the proposed standard, as written, provides an appropriate level of guidance on auditor independence. In particular, we are pleased that paragraphs 32-35 of the proposed standard incorporate GAO's two overarching principles for auditor independence. The GAO independence standard emphasizes a substance-over-form approach. We recommend that any additional requirements in the standards should take this approach, as follows:

> In making judgments on independence, audit organizations and audit committees should take a substance-over-form approach and consider the nature and significance of the services provided to the audited entity and the facts and circumstances surrounding those services. Before an audit committee approves and before an audit organization agrees to perform nonaudit services, careful consideration should be given to avoid situations that could lead reasonable third parties with knowledge of the relevant facts and circumstances to conclude that the auditor is not able to maintain independence in conducting the audits. It is imperative that auditors always be viewed as independent in fact and appearance.[2]

GAO issued its independence standard in January 2002,[3] and due to the many inquiries we received and the standard's significant effect on auditors of federal entities and programs, we subsequently provided additional guidance in the form of questions and answers to assist in implementing the standard.[4]

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[2] Adapted from *Government Auditing Standards: Answers to Independence Standard Questions* (GAO-02-870G, July 2002).
[3] *Government Auditing Standards Amendment No. 3: Independence* (GAO-02-388G, January 2002).
[4] *Government Auditing Standards: Answers to Independence Standard Questions* (GAO-02-870G, July 2002).

Additional GAO Comments

Nonroutine Transactions and Processes

Controls over nonroutine transactions and processes may be less well developed and more susceptible to management override and therefore have increased risk of being ineffective. In paragraphs 74-78 on identifying controls to test, we suggest that the standard provide a more explicit requirement on testing controls over nonroutine transactions and indicate that normally the auditor should expand testing of these controls. We also suggest that the discussion of fraud considerations in paragraphs 24-26 emphasize controls over nonroutine transactions.

Testing IT controls

Paragraph 41 of the proposed standard states that, when obtaining an understanding of the entity's internal control over financial reporting, the auditor should determine whether management has addressed the need to test controls "including information technology general controls, on which other controls are dependent." In addition, paragraphs 53 and 61 seem to make reference to IT controls as company-level controls, but they are not specific. We suggest that the standard be expanded to include general controls, application controls, and controls over IT security. We also suggest that the standard incorporate guidance as to what is needed to evaluate management's assessment process of these IT controls and for the auditor's testing of IT controls.

Paragraph 70 is unclear about how the requirements of AU 319 relate to this standard. Instead of referring to Paragraphs 16-20 of AU section 319, *Consideration of Internal Control in a Financial Statement Audit*, in paragraph 70 of the proposed standard, we suggest that the PCAOB update and expand the guidance of this AU section and include it in this proposed standard. In today's environment, auditors normally would not be able to attest to the effectiveness of an entity's internal control without understanding and testing relevant IT controls.

Materiality Considerations

We believe that the concepts in the second and third sentences of paragraph 21 of the proposed standard could more clearly convey that, depending on the facts and circumstances, the auditor should consider materiality at the financial-statement level and/or at the individual account-balance level in determining whether a deficiency represents a significant deficiency or a material weakness.

Materiality considerations for internal control over financial reporting would logically follow the materiality considerations for the financial statement audit. However, this is one area where we believe the financial audit standards need to be strengthened.

For instance, we suggest that financial auditing standards require the auditor to document (1) the planning materiality selected, (2) the method of determining planning materiality, (3) the auditor's consideration of materiality in designing the nature, timing, and extent of audit procedures, and (4) the auditor's consideration of materiality in evaluating the results of audit procedures. We encourage the PCAOB to give high priority to revising the interim standards on materiality, which are in AU section 312, *Audit Risk and Materiality in Conducting an Audit.* We believe that additional guidance on applying the concept of materiality is needed in areas such as estimating materiality, determining an appropriate materiality base, and applying materiality concepts in audit planning and reporting. We also believe that the standard should require auditors to quantify and document their consideration of materiality.

Illustrative Auditor Reports

- Unqualified Opinion, Example A-1

In the illustrative report expressing an unqualified opinion, we believe that the opinion paragraph should be revised to clearly state the following: (1) management's assessment of internal control over financial reporting, (2) whether the auditor agrees with management's assessment, and (3) the auditor's opinion on the effectiveness of internal control.

> Management has assessed the internal control over financial reporting of W Company, and has concluded that internal control over financial reporting was effective as of December 31, 20x3. We agree with management's assessment. In our opinion, ~~management's assessment that~~ W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20x3.~~, is fairly stated, in all material respects,~~ based on [identify criteria…]

- Adverse Opinion, Example A-2

In the illustrative report expressing an adverse opinion, we suggest that the last sentence of the explanatory paragraph should be revised as indicated below:

> …We considered this material weakness in determining the nature, timing, and extent of the audit procedures applied in our audit of the 20x3 financial statements. As a result of performing these revised audit procedures, we were able to express an opinion on W Company's 20x3 financial statements. However, information that management uses in making decisions during the year, as well as information presented in its quarterly reports, could be misstated as a result of the material weakness. ~~This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 20x3 financial statements, and this report does not affect our report dated [date of report…] on those financial staztements.~~

- Disclaiming An Opinion, Example A-4

In the illustrative report disclaiming an opinion, we believe that guidance is needed for an auditor's explanation of how the disclaimer on the effectiveness of internal control over financial reporting affects the auditor's opinion on the entity's financial statements.

- Report That Refers to the Report of Other Auditors, Exhibit A-5

In the illustrative report that refers to the report of other auditors as a basis, in part, for the auditor's opinion, we believe that the introductory and opinion paragraphs are unclear and suggest revision to clarify that the opinion and the responsibility belong to the auditor of the consolidated entity. Even when a wholly owned subsidiary is autonomous of its parent, the parent establishes the subsidiary's overall control environment and the "tone at the top." We suggest that the last sentence of the introductory paragraph be revised as follows:

> The effectiveness of B Company's internal control over financial reporting was audited by other auditors whose report has been furnished to us, and we considered their report and evidence obtained during our audit in order to form our opinion on the effectiveness of W Company's internal control over financial reporting. ~~our opinion, insofar as it relates to the effectiveness of B Company's internal control over financial reporting, is based solely on the report of the other auditors~~

- Combined Report, Example A-6

In the illustrative combined report expressing an unqualified opinion on financial statements and an unqualified opinion on management's assessment of the effectiveness of internal control over financial reporting, we suggest revising the opinion paragraph to state: (1) management's assessment of internal control over financial reporting, (2) whether the auditor agrees with management's assessment, and (3) the auditor's opinion on the effectiveness of internal control. This parallels our recommendation for revising the opinion of the illustrative report expressing an unqualified opinion in Example A-1.

> Management has assessed the internal control over financial reporting of W Company effective as of December 31, 20x3. We agree with management's assessment. Also in our opinion, ~~management's assessment that~~ W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20x3,. ~~, is fairly stated, in all material respects,~~ based on [identify criteria…]

Other Clarifications

- Clarify example of evaluating the operating effectiveness of internal control

In the second example provided in the last sentence of paragraph 93 of the proposed standard, reperforming the control is recommended as a procedure for testing the control. We do not believe that this procedure provides the auditor with evidence of the effectiveness of the control. We suggest that instead, the auditor should be advised to ask the person responsible for signing the voucher what he or she looks for when approving packages and how many errors have been found on vouchers. We also suggest that the auditor be advised to ask others with knowledge of the procedure about their understanding of the number of errors found. The auditor could also ask whether management has knowledge of any errors that the person responsible for signing the vouchers failed to detect.

- <u>Reconsider requirement regarding subsequent discovery of information existing at the date of the auditor's report on internal control over financial reporting</u>

The PCAOB should reconsider the requirement that the auditor determine "whether there are persons currently relying on or likely to rely on the auditor's report" as discussed in paragraph 180 of the proposed standard in the context of AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*. Specifically, the requirement for the auditor to determine "whether there are persons currently relying on or likely to rely on the auditor's report" is not always possible in light of today's technology. The auditor cannot reasonably determine who may rely on an auditor's report when these reports are readily available on the Internet, often from the Web site of the Securities and Exchange Commission.

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Gretchen R. Haggerty

Executive Vice President, Treasurer &
Chief Financial Officer

November 21, 2003

Office of the Secretary

Public Company Accounting Oversight Board
1666 K Street, NW
Washington, C 20006-2803

Subject: PCAOB Rulemaking Docket Matter No. 008

Ladies and Gentlemen:

These comments are submitted on behalf of United States Steel Corporation in response to the Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, (the Proposed Standard) contained in PCAOB Release No. 2003-017.

United States Steel Corporation supports and commends the PCAOB as it continues its rigorous efforts to implement new rules and regulations to improve the quality of audits, and thus their utility to investors. We offer the following comments with regard to the Proposed Standard.

With respect to the second to last paragraph preceding Question 11, although not stated directly, we are interpreting this paragraph to imply that if testing is performed earlier in the year, management, as well as the auditor, must perform additional testing at the end of the fiscal year. We feel that this would place an onerous burden on management and should not be required unless a change had occurred to materially impact reliance on the previous testing.

With respect to Question 17, we consider the use of the term “more than a remote likelihood” to be overly restrictive and having the potential to inappropriately render control deficiencies as significant and weaknesses as material. The word “remote” may move the bar so low that it is possible that all but an absolute lack of likelihood could be construed as more than remote. AU 325 defines a material weakness as a 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 may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We believe that this definition of a material weakness should be maintained.

We appreciate the opportunity to comment on the proposed statement. If you have any questions on our comments, please feel free to call me at (412) 433-4961 or Richard Belasco at (412) 433-5642.

Sincerely,

s/Gretchen R. Haggerty

United Technologies Corporation
United Technologies Building
Hartford, CT 06101

Jay L. Haberland
Vice President, Business Controls

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

November 19, 2003

Dear Sir or Madam:

Re.: PCAOB Rulemaking Docket Matter No. 008

We appreciate this opportunity to comment on the proposed auditing standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements. We applaud the Board's effort to strike an appropriate balance that considers the varied interests of the parties involved in the financial reporting process. We also appreciate the Board's willingness to seek comments to improve the proposed Standard.

The proposed Standard requires an audit of internal control over financial reporting, and the Release implicitly concedes that an audit of internal control over financial reporting is different from an audit of management's assessment of the effectiveness of internal controls over financial reporting. To preclude confusion, if the final Standard preserves the requirement for a scope that is more fairly characterized as an audit of internal control over financial reporting, we believe it would be better to expressly acknowledge the difference and set forth the reasons why the PCAOB believes that an audit of internal control over financial reporting is necessary to fulfill the requirements of the Act, Rules and sound policy.

In the proposed Standard, the PCAOB attempts to strike a balance between the exercise of judgment on the part of the auditor and prescription of specific audit rules. We strongly encourage the Board to focus on the exercise of judgment by the auditor in the final Standard. Several of the questions posed by the Board ask whether the final Standard should provide more specific direction to the auditor and, therefore, reduce the amount of judgment that the auditor can employ in certain situations. As we have seen with the promulgation of accounting principles, standards that are too prescriptive lend themselves to potential abuse through a strict interpretation of the "letter" vs. the "spirit" of the standard. This is particularly true in situations that deviate from the norm or those situations envisioned when the rules were developed. It is difficult to envision prescriptive rules that would apply equally well to a large, diversified, multinational, corporation and a small single segment business.

Our specific responses to the thirty-one questions posed by the Board are included as Attachment 1 to this letter. In general, we ask the Board to keep in mind that the process of maintaining a sound system of internal control is a dynamic one. As such, the requirements for these controls must: satisfy multiple constituencies by being useful for those employing the controls; allow for the application of the controls to ever changing situations; and, facilitate the on-going maintenance of the control system. Similarly, the evaluation of the internal control system by management must be meaningful and sustainable. Requirements which are inflexible or impose an unnecessary burden will be much more difficult to sustain and will diminish in their usefulness.

We would be pleased to discuss our comments with you in greater detail. Please feel free to contact the undersigned at (860) 728-7604.

Yours very truly,

Jay L. Haberland
Vice President, Business Controls

Attachment 1

Attachment 1

PCAOB Questions for Comment

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?**

   The proposed Standard requires an audit of internal control over financial reporting, and the Release implicitly concedes that an audit of internal control over financial reporting is different from an audit of management's assessment of the effectiveness of internal controls over financial reporting. Accordingly, it is not appropriate to imply that they are the same. To preclude confusion, if the final Standard preserves the requirement for a scope that is more fairly characterized as an audit of internal control over financial reporting, we believe it would be better to expressly acknowledge the difference and set forth the reasons why the PCAOB believes that an audit of internal control over financial reporting is necessary to fulfill the requirements of the Act, Rules and sound policy.

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?**

   This seems to us unnecessary as a practical matter. Section 404 of the Act and Rules require that the proposed audit of internal control over financial reporting be conducted by the issuer's independent auditor and not as an engagement separate from the annual audit of the financial statements. We believe that these Act-driven requirements are sound, because it will be far more cost efficient to have the same auditor perform both the audit of internal control over financial reporting and the audit of the financial statements. In particular, we believe that the scope of the audit of the financial statements can be appropriately adjusted to reflect the audit evidence gained from thoroughly evaluating the internal control over financial reporting.

   Therefore, the question would only have practical consequence if an issuer had some reason to require another separate audit of its internal controls over financial reporting. We are unable to imagine one, but if such a case exists, it is clear in theory that an audit of internal control over financial reporting is not identical to an audit of financial statements. The PCAOB's Release acknowledges that human behavior and compliance are an absolute limitation on the effectiveness of even well-designed and operated internal controls. For purposes, if any, that are distinct from satisfying the requirements of the Act and Rules, issuers should be free to procure audits of their internal controls over financial reporting without the necessity that such an audit scope include the financial statements themselves.

Attachment 1

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 is not clear to us what the advantage would be (from either a cost or efficiency standpoint) of requiring the auditor to perform a level of work comparable to that required to complete an audit of the financial statements but not also be responsible for the audit of those financial statements.

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?**

   The evaluation of internal control requires judgment. It also requires an understanding that inherent in the establishment of a system of internal control is the evaluation and assumption of risk. These factors should be considered both in the formulation of an appropriate system of internal control and in the evaluation of that system. For example, a small issuer might not be able to effectively implement the desired level of preventative controls but might be more able than a larger business to effectively implement and carry out "after the fact detective controls." The auditor must consider these differences in his or her evaluation of control and be astute enough to evaluate a particular control in a given circumstance. Appendix E should expressly address this possibility, so that auditors will be more comfortable making such judgments.

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 audit 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.**

   The example provided is sufficiently clear that it seems unlikely to occur. Beyond such an easy case, we do not believe that a level of specificity greater than that contained in paragraph 31 regarding qualifications of the auditor is necessary or advisable. The original generally accepted auditing standards required that audit work be performed by "persons having adequate technical training and proficiency as an auditor." It would also not be realistic (if even possible) to specify the level of competence and training necessary for all the situations that might be encountered.

Attachment 1

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?**

As a normal outgrowth of expressing an opinion on management's assessment, we would expect the auditor to directly obtain a certain amount of evidentiary matter. However, because a major emphasis of the auditor's work should be directed toward opining on management's assertion, we would expect the auditor to focus heavily on the work performed by management and others. We would expect the auditor to perform enough work to determine the veracity of the work performed by management and others to support their assessment of the internal control over financial reporting.

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

We are concerned that the criteria set forth in paragraph 43 could be too narrowly interpreted by the external auditor as being required for each element of documentation. The Board's guidance regarding documentation contained in paragraph 44 is appropriate. Above all, documentation should be useful for the users and sustainable over the long term. Documentation requirements that are too prescriptive run the risk of reducing the usefulness of the documentation and increasing the likelihood that it will not be properly maintained.

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 a significant deficiency or material weakness in internal control?**

The determination that documentation is inadequate implies that, the lack of proper documentation has caused the internal control over financial reporting to function in a less than adequate fashion. The auditor should consider the outcome from the lack of proper documentation. The lack of proper documentation, in and of itself, may or may not rise to the level of a significant deficiency or a material weakness. As with any other deficiency, the auditor should evaluate the significance of the weakness in light of the overall system of internal control

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

Walkthroughs should be treated as any other audit test. The auditor should be permitted to use judgment in determining when walkthroughs are appropriate and whether they need to personally perform the walkthrough or can rely on a walkthrough performed by management or others.

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?**

    As indicated in our response to question 9, the decision regarding whether the auditor needs to personally perform the walkthrough or can rely on a walkthrough performed by management or others should be left to the judgment of the auditor. This decision needs to be performed on a case-by-case basis and should consider the significance of the area being reviewed and the expertise of the party performing the walkthrough. The proposed auditing standards should not preclude the auditor from using walkthrough procedures performed by third parties, especially internal auditors or other audit professionals hired by management to perform reviews of internal controls.

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?**

    The auditor, in conjunction with management, should be required to determine if significant changes in internal control over financial reporting have occurred from year to year. If no significant changes have occurred, the auditor should be able to limit his or her work to determining that the internal controls still function as intended. This would limit the need to obtain evidence for all assertions or significant accounts each year.

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

    The auditor should be permitted to exercise professional judgment to use the work of management and others. The auditor should only be required to perform enough work on their own to determine that the work of management and others is credible. The final auditing standards should not establish detailed prescriptive measures of when the work of management or others cannot be used. This would be consistent with the concept embodied in the Act and Rules that the auditor is opining on management's assertion regarding the effectiveness of internal control over financial reporting.

Attachment 1

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

We believe that the three categories of control and the degree to which the auditor may rely on the work of others are too narrowly defined in the sense that they appear to severely limit the amount of reliance that the auditor can place on the work of others. We believe that the auditor should be permitted to exercise judgment in determining where they may place reliance on the work of others. Preliminary discussions with our external audit firm would indicate that they believe the amount of reliance that they may place on the work of others, including internal audit, would be very limited under the proposed Standard.

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?

The auditor should have the ability to exercise judgment in deciding when to use the work of internal auditors just as they do when deciding when it is appropriate to rely on the work of others. They need to assess the quality, competence and credibility of any third party (management or others) upon which they may choose to rely. They then need to evaluate the situation in which they intend to rely on the work of others on a case-by-case basis. Once again, the final auditing standards should not establish detailed prescriptive measures of when the work of management or others cannot be used.

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)?

The auditor must be permitted to exercise judgment in determining to what extent they need to reperform the work of others. The greater the level of work performed by others upon which the auditor intends to rely, the greater the level of comfort they would need in the quality and credibility of that work. We strongly urge the Board to not further curtail the auditor's ability to exercise judgment. In our opinion, to do so would substantially increase the costs of the audits of internal control over financial reporting and preclude the exercise of appropriate professional judgment in such examinations. As management is required to exercise judgment in making their assertion, so should the auditor be in assessing management's assertion and the effectiveness of the internal control over financial reporting. Once again, the final auditing standards should not establish detailed prescriptive measures of when the work of management or others cannot be used.

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?

The auditor's conclusion regarding the effectiveness of internal control over financial reporting should be based on all of the evidence obtained by the auditor. The specific source of the evidence should be left to the professional judgment of the auditor but the auditor should be required to evaluate credibility of the source from which the evidence was obtained.

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?

We do not believe that the new definitions of significant deficiency and material weakness will significantly alter the consistency in evaluation of weaknesses. Given that the determination of a significant deficiency or material weakness involves judgment, we would not recommend that the Board attempt to provide additional clarification. However, it would be helpful for the Board to reconcile the auditor's responsibility for reporting significant deficiencies and material weaknesses under the proposed standard with their existing responsibilities with respect to audits of financial statements. Presumably, the auditor should have previously reported these deficiencies and weaknesses to the registrant.

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 the commenters could suggest that would provide further interpretive help?

We believe the Board should exercise caution in determining when and whether to provide examples of significant deficiencies and material weaknesses. The determination of these conditions requires the exercise of considerable judgment on the part of management and the auditor and must be evaluated in light of a number of factors. We are concerned that the auditor could too narrowly construe the examples and restrict the exercise of judgment in their evaluation.

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

The auditor must always evaluate the severity of an identified control weakness to determine what, if any, action is to be taken. The auditor must also always evaluate the severity of identified weaknesses in the aggregate, as well as individually. It is quite possible that for minor deficiencies the evaluation will be relatively informal.

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. This is no different from the past when auditors would communicate the internal control deficiencies through a management letter.

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

Yes, however, the auditor must still use judgment to evaluate these indicators before reaching the conclusion that a significant deficiency or material weakness exists.

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?

One could argue that there is a potential conflict of interest in asking the auditor formally to evaluate the committee charged with selecting, engaging and supervising the auditor. Indeed, this principle is normally considered essential to the effectiveness of significant internal controls (e.g. approval of expense reports) and forms the basis of significant personnel policies in most companies. We believe that, rather than "evaluate" the committee's performance, the auditor should identify and recommend policies and processes to the audit committee, where appropriate, to ensure that the committee receives all material information required to fulfill its responsibilities to oversee the issuer's external financial reporting.

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

See answer to question 22.

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?

See answer to question 22. If the final Standard preserves the concept that the independent auditor should evaluate the effectiveness of the audit committee, we think that the decision on whether to issue an adverse opinion or withdraw from the audit engagement should be left up to the auditor.

Attachment 1

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?

While the distinction is probably not particularly meaningful, the sample opinions in Appendix A are inconsistent. The "unqualified" opinion expresses an opinion on management's assessment while the "adverse" opinion expresses an opinion on the system of internal control over financial reporting and not on management's assessment as required by paragraph 153 (l) of the proposed standard. It seems to us that the auditor should be held to the same reporting standard in terms of what is reported on (i.e. management's assessment or the system of internal control) regardless of their opinion.

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

No.

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 internal control over financial reporting rather than to whether management's assessment is fairly stated?

This gets to the question of whether the auditor is opining on management's assertion or on the internal control over financial reporting. If the auditor is opining on management's assertion, the auditor's opinion should state whether management's statement is correct.

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

We do not believe than any guidance beyond that already mandated is necessary.

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

The auditor should be prohibited from performing all internal-control related non-audit services for their audit clients.

30. Are the auditor's differing levels of responsibility as they relate to management's quarterly certifications versus the annual (fourth quarter) certification, appropriate?

We believe that the differing levels of responsibility are appropriate.

Attachment 1

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

We believe that the scope of the auditor's responsibility for quarterly disclosures is appropriate.

From: Eleanor Bloxham [ebloxham@thevaluealliance.com]
Sent: Friday, November 21, 2003 4:12 PM
To: Comments
Subject: Docket 008

Thank you for the opportunity to comment.

Comments on the Paragraphs:
The wording in paragraphs number 5 and 28 are important. I agree with the wording and do not believe it should be diluted.

Regarding paragraphs 21, 22, and 23: Because of the critical importance to many constituents, it should be made clear that the issues of materiality should also apply to FAS 131 segment reporting.

Regarding paragraphs 32, 33, 34 and 35, Having the same external auditor make "substantive recommendations as to how management may improve the design or operation of the company's internal controls" and also audit those controls does not represent independence. There are plenty of resources for managements beyond external auditors, including professional organizations like the Institute of Internal Auditors, and other audit related firms and consultancies who are well equipped to make "substantive recommendations as to how management may improve the design or operation of the company's internal controls". I strongly urge you to address this issue and not permit the external auditor to provide internal control services. Even if it passes the fact test (and human nature would make that difficult in terms of objectivity), it does not pass the appearance test. (Anonymous 22 shows the difficulties this can cause real people.)

The wording of paragraph 46 appears to be appropriate.

Regarding paragraphs 56, 57, 58 and 59: Having the external auditor who is hired by the audit committee evaluate the audit committee is inappropriate and may be meaningless (have no teeth). I agree with Mr. William McDonough's statement in the Financial Times that it is problematic. If a statement of evaluation of the audit committee is to be made and to be meaningful, it should be made by a third party approved by shareholders, in a separate evaluation, not by the external auditor. To have this evaluation made by the external auditor undermines the accountability of the external auditor to the audit committee.

Regarding paragraphs 60 -65: Although paragraph 63 alludes to FAS 131 segment reporting (arguably one of the most important sets of information to investors), the significance of segment reporting itself (as opposed to the accounts within a segment) is not adequately addressed. Because of the critical importance to many constituents, it should be made clear that the issue of "significance" not only applies to significant accounts but also to FAS 131 reportable segments.

Regarding paragraphs 190, 191, 192 and 193, all deficiencies and acts of fraud or illegality should be reported to the audit committee who has hired the external auditor for the purpose of their assessments. This information provides an early warning signal to the committee of potential cultural issues that may need to be addressed at the senior management level. At a minimum, audit committees should be the ones to direct the level of detail they should receive (beyond that currently specified in these paragraphs) and external auditors should be required to seek that guidance. The rules should not limit or imply a limit of information flow to the audit committee, nor should the external auditor determine the full extent of information they will provide based on their own interpretations of PCAOB rules.

Comments on the Questions:
I agree with the American Accounting Association's answer to question 4. New sentencing guideline recommendations in the area of compliance also support the idea that small companies will need control structures in place to meet those requirements as well.

Regarding question 5, specification would be useful. Commenter Anonymous 22 alludes to potential competency issues with perceived little recourse. Specification could help. Also, since the external audit team is hired by the audit committee, it would be appropriate for the audit committee to perform an annual evaluation of the audit team and its members (using input as required) - with a report to the supervisor of the partner in charge on issues to be addressed in team composition and skills required for future audits. This approach could be useful in improving the quality of audits especially given that a company's strategic areas of focus may change over time and require changing specialized expertise.

Regarding questions 6 and 7, the scope is appropriate and should specify obtaining direct evidence, and the guidance is useful.

Regarding questions 9 and 10, the requirements are justified.

Regarding questions 12 - 16, it is appropriate to say that "the auditor's own work must provide the principal evidence for the audit opinion."

Regarding questions 22 and 23, see comments on paragraphs 56, 57, 58 and 59 above.

Regarding questions 28 and 29, see comments on paragraphs 32 - 35. There are no circumstances under which the external auditor should provide internal control services. It is a conflict of interest and compromises external auditor independence by creating the appearance, if not the fact, of lack of independence. A similar analogy is external auditors' involvement in consulting services with respect to financial systems, which is now prohibited.

If you have any questions or comments on any of the above, please feel free to call me at 614-571-7020 or email ebloxham@thevaluealliance.com.

With best regards,

Eleanor Bloxham
President, The Value Alliance
and Corporate Governance Alliance
www.thevaluealliance.com

From: Vanzanen, Roger [Roger.Vanzanen@premcor.com]
Sent: Wednesday, November 12, 2003 12:13 PM
To: Comments
Subject: PCAOB Rulemaking Docket Matter No. 008

Sirs:

I believe the rule proposes inadequate audit activities with regard to management's Notes and MD&A to the Financial Statements, Its Certifications with regard to the Disclosure Process (Section302) and the Internal Controls surrounding that disclosure process which would assure that all disclosable items are considered for disclosure.

1. I believe the Directive now contained at SEA(1934) 13a #5. "No person shall knowingly circumvent or knowingly fail to implement a system of internal accounting controls or knowingly falsify any book, record or account described in paragraph (2)", must be certified by management and the basis for that assertion must be adequately audited by the external auditor.

2. The matters for Section 302 Certification include: 1. No untrue statements of material facts, 2. No omissions of material fact, 3. Fairly present (which by logic includes compliance with Section 401 disclosures including those concerning Off-Balance Sheet relationships), 4. Disclosure control design, 5. Internal control evaluation at end of period, 6. Conclusion formed by the Internal Control evaluation is presented in the filing, 7. Have disclosed all significant weaknesses to the auditors and Audit Committee, 8. Have disclosed any fraud by an employees with significant internal control responsibility, 9. Have disclosed in the filing all significant changes in Internal Control, including corrective actions, 10. Under 401, the existence and operation of the Disclosure
Committee, 11. Under 403, transactions by management and principal Officers (Section 16), 12. Under 406, the existence of a Code of Ethics, 13. Under 407, the Financial expert on the Audit Committee, 14. Under SEA(1934), Section 13a. Directive 5. "No person shall knowingly circumvent or knowingly fail to implement a system of internal accounting controls or knowingly falsify any book, record or account described in paragraph (2)". The Company's Code of Conduct should include prohibitions against: 1. Conflict of Interest, 2. Giving gifts, 3. Receiving gifts, 4. Competition with the company, 5. Non-compliance with laws and regulations, 6. Fraud, including tampering with records, mail and wire fraud, providing untruthful or misleading supporting documentation for company payments and
causing transactions to be recorded incompletely or inaccurately, 7. The
use of unrecorded company funds, 8. Failure to cooperate with auditors or
attempting to influence them unduly or misleading them, 9. Insider
Trading violations.
Management's design of a data collection process that justifies these assertions by the CFO/CEO might include an annual cascading representation against a checklist of all relevant compliance issues and quarterly "negative assurance" against that same list, supplemented by specific responses in their areas of expertise by designated Subject Matter Experts.

The effectiveness of the process behind the 302 Certifiation should be commented on by the Auditor, whether or not he feels it is adequate.

Roger Van Zanen
Internal Audit
fax 314-719-8150
414-975-2721 in Milwaukee
262-754-0616 at home
rognaree@hotmail.com

From: Curt Verschoor [cverscho@condor.depaul.edu]
Sent: Friday, November 21, 2003 4:34 PM
To: Comments
Subject: Docket 008

General Comments:

1. In Paragraphs 13 and 14, the Exposure Draft (ED) sets forth the COSO Framework as suitable for use in developing management's assertion and presumably, the auditor's attestation. The ED also refers to COSO's important place in the auditing literature regarding internal control in AU 319. In spite of this, however, the ED deviates from the established standard of internal control effectiveness contained in COSO, the presence and effective functioning of all five internal control components. By adopting a new effectiveness standard based on absence of identified material weaknesses, the ED focuses too much context on only one COSO component, control activities.

Granted, the need to consider all five components has been inserted in various paragraphs, including 43, 80, 101. Nevertheless, the overall thrust of the document concerns specific controls concerning assertions that relate to: 1) significant accounts and disclosures (¶ 41, 43, 45, 74, 75), 2) significant processes (¶ 69, 79). There is insufficient reference to the auditor's need to assess the strength of overall controls.

Because of emphasis on specific transaction-based controls, rather than company-wide and more general controls, the internal control evaluation process risks becoming merely an automated box-checking process. Excessive costs and efforts may thereby be spent on the documentation and testing of routine transactions, and insufficient efforts on the controls resulting from operation of the control environment and risk assessment. The Board is no doubt aware of the marketing efforts of consultants and software developers who promise easy compliance with repetitive aspects of controls identified with specific transactions.

2. Because of its importance and the fact that it has a pervasive effect on internal control, an expanded several paragraph discussion of the control environment, including integrity and ethical values, should be set forth at the beginning of the ED, perhaps before ¶ 24. Thereafter, the ED should guide the auditor to consider controls that result from the control environment in each aspect of the audit.

As stated in the AICPA Audit Guide on internal control: *"The effectiveness of internal control cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical values are essential elements of the control environment, affecting the design, administration, and monitoring of other internal control components."*

Section 301 of The Sarbanes-Oxley Act of 2002 requires public company audit committees to establish procedures for employees to confidentially submit complaints about internal controls. In addition, the recently enacted listing standards of the stock exchanges require companies to have a code of conduct and effective compliance measures. Consequently, inadequacies in either of these two areas should be included in ¶ 126 as a strong indicator of a material weakness. (See below).

3. The subject of risk assessment also requires expanded coverage in the ED. Otherwise, unnecessary efforts may be expended in evaluating the design, functioning, and monitoring of controls (for example, over routine recurring transactions) where there is a limited risk of material misstatement. The auditor should concentrate his/her efforts where risks are highest. Therefore, the auditor's evaluation of the client's risk assessment should precede the auditor's understanding of existing internal controls in Paragraph 48. A listing of factors that would alter risks relevant to financial reporting would be helpful:

- Changes in operating environment
- Changes in management structure, acquisition or divestiture
- New personnel or personnel reductions
- New or revamped information systems
- Rapid growth, new products or production processes
- Developments in foreign operations
- New accounting pronouncements

Specific Comments:

1. In ¶ 19, a reference to ¶ 50 may be helpful.
2. Factors contained in ¶ 24 transcend fraud considerations and should not be identified as necessarily fraud-related. A listing of the red flags from AU 316 would be helpful in alerting the auditor.
3. In ¶ 50, the reference should state 'the design of control resulting from the operation of all five control components.
4. Some references (¶ 80, 101) to the five components of internal control describe the need to consider 'the controls for all components.' The five components are not control objectives. Rather these references should state a need to consider 'the controls resulting from the operation of all five control components.'
5. "Ineffective procedures to ensure compliance with either the entity's code of conduct or with procedures designed to enable employee complaints on internal controls over financial reporting" should be added to ¶ 126.

Answers to questions:

1. Yes, so long as there is reference to the fact that it is an attestation of management's assertions.
2. Yes
3. No, this does not appear to be economically feasible.
5. If expressed in the positive, ie, the qualities necessary for effective auditing, then OK.
6. Yes
7. Yes
8. Yes
9. Some walkthroughs are helpful and necessary, but the ED should not imply or even hint they are required for every significant account or process every year. The ED should clarify this point.
10. No, as some authorities believe walkthroughs are helpful in pointing out only the most egregious control weaknesses.
11. Audit evidence gathered in previous years may be used if the auditor is satisfied that no changes have occurred.
14. Not enough, if the auditor is able to satisfy him/herself of the quality of the internal audit

activity.
19. Yes
20. Yes
21. No, see addition at Specific Comment No. 5 above.
22. Not as an end in itself, however, the auditor must include an evaluation of the strength of the controls added by the audit committee in his/her overall assessment of controls over financial reporting.
23. Yes, if they follow present and future (expanded) ethical guidelines.
24. No
28. Yes, and clarify and restate the guidance already given through FAQ's.
29. Yes, and they have already been stated, but apparently not in sufficient clarity.

Respectfully submitted,
Curtis C. Verschoor
Research Professor, School of Accountancy and MIS
DePaul University

November 14, 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

We appreciate the opportunity to provide comments to the Public Company Accounting Oversight Board (PCAOB) regarding the Proposed Auditing Standard, "*An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*".

We have two specific comments that we respectfully submit to the PCAOB for your consideration. Our suggestions address the following requirements of the standard:

- Level of testing required
- Effective date

Level of testing required

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

We agree with the proposed standard allowing the auditors to rely on the work of management and others, however, we believe the prohibition against reliance in two of the areas, specifically the period-end financial reporting process and IT general controls, is not appropriate.

Excerpts from the draft standard currently state: *There are a number of areas in which the auditor should not use the results of testing performed by management and others, including:*

- *Controls that are part of the control environment, including controls specifically established to prevent and detect fraud…*
- *Controls over the period-end financial reporting process, including controls over procedures used to enter transactions totals into the general ledger; to initiate, record and process journal entries in the general ledger; and to record recurring and nonrecurring adjustments to the financial statement (for example, consolidating adjustments, report combinations and reclassifications).*

- *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.*
- *Walkthroughs…*

For large multi-national companies with internal audit departments that have a high degree of competency and objectivity, it seems overly prescriptive for the standard not to permit any reliance on the results of testing performed by management or others on the (1) period-end financial reporting process and (2) information technology general controls where management can demonstrate the objectivity and competence of those performing the tests. We feel it would be better to leave the degree of reliance up to the auditors in these two areas rather than having the standard state that no reliance can be placed.

Effective Date

We believe a delay in the effective date of the rules consistent with the timing of the issuance of the final standard by the PCAOB is necessary to provide additional time for companies and their auditors to adjust work already completed for any changes made to the proposed standard and to adequately develop testing plans, train staff and document the performance of the required testing.

Assuming the PCAOB issues its final standard by the end of December, companies with non-calendar year ends (e.g. June 30^{th} and September 30^{th}) and their auditors will be operating under compressed time frames in order to comply with the final standard. If the final standard is issued any later than December, the issue will be further exacerbated. Many consultants are recommending that companies should be complete with documentation and testing three to six months prior to yearend to ensure adequate time for the audit process, issue resolution and any desired remediation activities; a June 30 or September 30 year end company following this best practice would have very little time to comply, if the final standard is issued in late December. Accordingly, assuming a final standard is issued in December, we recommend that the Section 404 reporting requirements be effective for fiscal years ending after December 15, 2004.

Thank you for considering our comments on the proposed auditing standard. We would be happy to discuss our concerns in more detail, if desired.

Sincerely,

/s/ Brent A. Woodford

Brent A. Woodford
Senior Vice President, Corporate Controllership
The Walt Disney Company
(818) 973-4030

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Re: PCAOB Rulemaking Docket Matter No. 008

Comments on Proposed Auditing Standard-

An Audit of Internal Control over Financial Reporting Performed In Conjunction with an Audit of Financial Statements

After careful review of the standard on auditing internal control as part of the financial statement audit it is clear that the standard intends to accomplish both adequate reliance on the underlying internal control and also the financial statements. The auditor would be required as part of the financial statement audit to obtain all the necessary understanding of the systems in place to design and test the system in rendering an opinion on the system of internal control and the financial statements.

While we realize this is a major initiative for each firm in executing this plan it is also a major initiative for any organization that might be subject to the standard. There is sure to be a need for greater staffing at both the accounting firm and at the organization to meet the need of adherence to this standard. With that in mine, there will be far greater costs associated with this standard for the organization. This will indeed affect management planning initiatives and the overall strategies that may exist in any organization.

To this end, we suggest this standard require public accounting firms engage the use of smaller firms, including minority owned accounting firms, to assist in their performance of the work required related to internal control. We believe the access to greater markets, so often sought by smaller firms and, the lower cost structure would benefit both any organization and also do greater good in opening access to the market place for those firms who have never received this opportunity. The larger firms could provide oversight in the review of the work to maintain assurance in opining on internal control. The standard does provide some guidance on this issue under "using the work of Management and Others," which clearly stipulates that such a practice is acceptable.

Should you have any questions or require additional information, please call me at (212) 447-0813.

Sincerely,
Watson Rice LLP

Raymond P. Jones, CPA, CFE
Managing Partner

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November 14, 2003

Public Company Accounting Oversight Board

Via e-mail and attachment

Release No. 2003-17

Dear Sirs:

I am writing to comment on the above-release.

I am a former SEC staff member now in private practice. I primarily represent small businesses seeking to secure a qualification for quotation for their securities on the over-the-counter bulletin board. I currently represent 10 companies trading on the over-the-counter bulletin board.

It was with great dismay that I note numerous references to an audit committee and independent directors in the Release. The Release presupposes that all OTCBB issuers must have independent directors and audit committees. The release implies that the failure of an OTCBB SEC reporting issuer to have an audit committee could lead to a conclusion that the issuer is somehow in violation of Section 404 of the Sarbanes-Oxley Act and/or that an auditor of such an issuer would not be able to issue an unqualified 404 certification.

THIS CONCLUSION IS INCORRECT AND IS IN FACT DIRECTLY CONTRARY TO CONGRESSIONAL INTENT.

Although most provisions of the Sarbanes-Oxley Act apply to small business OTCBB issuers, in Section 301 of the Act, Congress specifically exempted OTCBB issuers from the independent director/audit committee requirements.

"Section 301. Public Company Audit Committees" of the Act provides as follows:

> Section 10A of the Securities Exchange Act of 1934 (15 U.S.C. 78f) is amended by adding at the end the following:
>
> (m) STANDARDS RELATING TO AUDIT COMMITTEES –
>
> (1) COMMISSION RULES

> (A) IN GENERAL - Effective not later than 270 days after the date of enactment of this subsection, the Commission shall, by rule, direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the requirements of any portion of paragraphs (2) through (6).

As noted on the SEC's website:

> Will the rules relating to Section 301 apply to issuers whose securities are traded on the over-the-counter bulletin board market?
>
> Answer: No. Securities traded on the over-the-counter bulletin board market currently are not considered listed securities.

In Section 301, Congress clearly indicates that the lack of an audit committee or independent directors should not be considered in determining compliance by an OTCBB issuer with the Act, including Section 404, so long as the OTCBB issuer otherwise was in compliance with the Act, including Section 404. Certainly Congress was not saying OTCBB issuers explicitly don't need independent directors and audit committees in Section 301 but somehow do need them to be in compliance with the Act, including Section 404. Such a conclusion would be illogical.

If Congress thought independent directors and audit committees were a consideration in determining compliance by OTCBB issuers with the Act, including Section 404, they would not have written Section 301 the way they did. Indeed, a conclusion that the lack of an audit committee or independent directors should be considered in determining compliance by an OTCBB issuer with the Act, including Section 404, would make Section 301 irrelevant, which is certainly not consistent with congressional intent.

As Congress clearly and explicitly concluded that OTCBB reporting issuers do not need independent directors or an audit committee to comply with the Act, it would be completely inappropriate for the PCAOB to bootstrap in such requirement, in a manner directly contrary to congressional intent, through an implication that the failure to have independent directors or audit committee should somehow be a consideration in determining compliance by and OTCBB issuer with the Act, including Section 404, or that an auditor of such a company would have to consider the issue in making an unqualified 404 certification in these circumstances.

What should the PCAOB do: Revise the release to be consistent with congressional intent by clarifying that the lack of independent directors or an audit committee in small business OTCBB issuers who are not required to have them under Section 301 of the Sarbanes-Oxley Act will not be a consideration in determining compliance by an OTCBB issuer with the Act, including Section 404 and that auditors for these issuers need not consider the issue in making an unqualified 404 certification so long as the same type of communication, analysis and interaction the Release indicates must be made with an audit committee is made to or with the entire board of the OTCBB issuer.

This is consistent with Section 205(58) of the Act which provides:

SEC. 205. CONFORMING AMENDMENTS.

DEFINITIONS- Section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)) is amended by adding at the end the following:

(58) AUDIT COMMITTEE- The term `audit committee' means--

(A) a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and

(B) <u>if no such committee exists with respect to an issuer, the entire board of directors of the issuer.</u>

Thank you for your consideration.

Sincerely,

/s/ Michael T. Williams, Esq.

Michael T. Williams, Esq.

November 21, 2003

Via Electronic Mail

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 – Proposed Auditing Standard – An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

Ladies and Gentlemen:

Wells Fargo & Company is a diversified financial services company with over $390 billion in assets providing banking, insurance, investments, mortgage and consumer finance. We appreciate the opportunity to comment on the proposed auditing standard ("Proposed Standard"), recently published by the Public Company Accounting Oversight Board (the "Board"), covering internal control over financial reporting implementing Section 404 of the Sarbanes-Oxley Act of 2002 (the "Act").

We support the Board's efforts to establish standards to carry out Section 404 of the Act but have outlined below strong reservations about aspects of the Proposed Standard.

Extent of Work to be Performed by Auditor is Excessive

We believe that the Board has unnecessarily gone beyond the statutory requirements of Section 404 of the Act by requiring the independent auditor to audit and report upon a company's internal control over financial reporting instead of attesting to management's assertion regarding the effectiveness of those controls. In light of the work that management must perform under Section 404 of the Act, the ongoing activities of the internal audit function and the work performed by the independent auditor during the course of the financial statement audit, the requirement to separately audit the controls in lieu of attesting on management's assertion is redundant.

Auditor's Professional Judgment is Overly Restricted

We believe the Board should permit independent auditors to rely upon the work of others, including the internal audit function, in fulfilling responsibilities under the Proposed Standard. SAS 65[1] provides an appropriate framework for auditors to use their professional judgment to determine when and to what extent they should rely on the internal audit function. The strength of the internal audit function, the overall control environment and management will vary from company to company and industry to industry and auditors should be able to adjust the extent of their testing accordingly. For example, as an insured depository institution and bank holding company, we are required by the Federal Deposit Insurance Corporation Improvement Act of 1991 to make an annual assertion regarding the effectiveness of our internal control structure and procedures on which our auditor opines. Consequently, we already use reliable and tested internal systems to monitor our control effectiveness. Prohibiting auditors from using their discretion to determine the level of reliance and extent of testing over these systems would subject us to significant additional cost yielding little or no improvement in the reliability of these controls.

In addition, we believe the requirement in paragraph 109 of the Proposed Standard that the auditor's own work serve as the principal evidence for its audit opinion should be removed from the Proposed Standard and the requirement to obtain sufficient competent evidence to support the opinion should be retained. The auditor should be able to obtain sufficient competent evidence to support its opinion, whether that evidence is derived principally from the auditor's own work or from reliance on others. Qualitative restrictions on the reliance an auditor can place on other's work is appropriate, but quantitative thresholds should not be imposed.

Remote Threshold is Not Workable

The Proposed Standard would preclude an auditor from giving an unqualified opinion if the auditor identified a "material weakness," defined as any significant deficiency that results in more than a remote likelihood 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 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 the rules covering Section 404 of the Act, the SEC defined material weakness by reference to current accounting literature, as a "reportable 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.[2] We urge the Board to take a similar approach, and to define material weakness as a significant deficiency that results in a "reportable 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*. We do not think that the definition of material weakness will be workable unless the Board uses the same definition of material weakness used by the SEC.

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

[2] 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 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 concepts of "remote" and "more than an inconsequential amount" sets far too low a threshold and should be replaced with the SEC language of reducing to a "relatively low level" that a significant financial misstatement will not be prevented or detected. Furthermore, the use of different terms in reference to the same section of the Act will result in significant confusion in practical implementation.

Guidance Required for Audit Report Bring-down Procedures

We believe that it is vitally important that the Board clarify in paragraph 181 of the Proposed Standard the scope of the required bring-down procedures with regard to the filing of auditor consents (*e.g.,* relating to registration statements) because these consents can occur numerous times throughout the fiscal year and on relatively short notice. As currently drafted, the extent of the bring-down procedures required by the Proposed Standard may not be practical, particularly by large diversified organizations given the timing of these consents. As a practical alternative, we propose that the bring-down procedures be applied only to material adverse changes in controls.

Remove Prescriptive List of Strong Indicators of Material Weaknesses

Paragraph 126 of the Proposed Standard would mandate that auditors conclude any one of the various conditions noted as a significant deficiency and "a strong indicator" that a material weakness may exist. The list of strong indicators contained in paragraph 126 includes any material misstatement in a current period that was not initially identified by a company's internal control over financial reporting. Audit adjustments are often made to balances 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 collectibility of loans and about the probability and potential magnitude of contingent liabilities such as those arising from pending litigation. The Proposed Standard should permit auditors to use professional judgment in determining whether an audit adjustment is attributable to a material weakness in internal control over financial reporting and should not impose a presumption in this regard.

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. In circumstances where these events occur late in the audit cycle, it may not be possible to evaluate internal control for the combined company without relying on the work of management and the auditor of the acquired company. 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.

* * * * * *

We appreciate the opportunity to comment on proposed standards of the Board. If you have any questions, please contact me at (415) 222-3119.

Sincerely,

/s/ Richard D. Levy

Richard D. Levy
Senior Vice President, Controller

H. W. Willoughby

November 20, 2003

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

Re.: PCAOB Rulemaking Docket Matter No. 008

Thank you for the opportunity to comment on the proposed auditing standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements. In general, the PCAOB is to be commended for attempting to comply with the unrealistic deadlines and requirements imposed by a law that was rushed through the political smoke and haze created by the colossal failure of large public companies and large public accounting firms during the final phases of another classic bubble in the stock market.[1] However, this well intended "rush to comply" has resulted in the publishing of a draft auditing standard that contains several material weaknesses and significant deficiencies that should be remedied before the final standard is issued. A summary of such items is included in Attachment 1, together with comments on selected questions posed by the PCAOB in the preamble to the draft standard.

Plopping down the conceptual COSO framework (1992), which is largely obsolete as measured in 2003 internal control currency, as the gold standard for righting the wrongs of the aforementioned "bubble" is also fraught with significant problems. COSO is an interesting thought piece, which provides very little practical implementation guidance. It stands as hollow shell testimony to the most recent previous significant bubble of S&L failures and financial reporting frauds in the 1980's. This misguided attempt to "right the wrongs" conjures up images of the big parade scene at the end of the movie Animal House, except this time, the PCAOB and SEC staffers are sitting behind the wheel instead of John Belushi and an oversized COSO cube is stuck to the front bumper of the vehicle, which is careening madly down regulatory lane.

Having spent the large majority of my career in the auditing profession, both external and internal, it is almost painful to read the proposed PCAOB auditing standard. Many of the terms of art embodied in the now "capped off" AICPA standards have been twisted almost beyond recognition in the draft standard. To add insult to injury, explanatory footnotes have not been added to

[1] Reference *Extraordinary Popular Delusions And The Madness Of Crowds*, Charles MacKay, 1841

these mutations so that the trained professionals can follow this kitchen sink attempt to write an auditing standard on internal control over financial reporting.

Preparation of financial statements and the related internal control over financial reporting are quintessential derivatives of business operations. Please take the time to consider all of the recommendations made by the various constituencies so that these derivatives are properly accounted for by management and audited by the external auditors.

Sincerely,

H. W. Willoughby

General Comments:

A. **Implementation Dates** – The extended June 15, 2004 effective date is ridiculous given the enormity of your undertaking. Regardless of election year pressure, do not give in to the long-standing practice of providing sufficient time for transition. At a minimum, consider moving the date back to December 15, 2004.

B. **Information Technology** - The draft standard is woefully inadequate in its attempt to address the role of information technology in businesses today, including its integral use in preparing financial statements and the related internal control over financial reporting. COSO is also bereft of meaningful guidance on information technology, leaving a huge void in this critical area.

In an attempt to provide something where nothing exists, the Big 4 firms used ISACA to sponsor an October 2003 publication entitled **IT Control Objectives for Sarbanes-Oxley – The Importance of IT in the Design, Implementation and Sustainability of Internal Control Over Disclosure and Financial Reporting –** www.isaca.org.

In keeping with the spirit of rushing a standard in to meet an already extended deadline, PCAOB should strongly consider incorporating by reference, much like the COSO "pull in", the extruded CoBIT thought piece discussed above. Although far from perfect (and ignoring for now the additional billing opportunities teed up by the Big 4 for themselves), something is better than nothing in this case. (The ISACA document contains SEC and PCAOB disclaimers, which ostensibly could be removed if incorporated by the new PCAOB standard.)

C. **Internal Auditing** – The best positioned Internal Audit departments live in the gray space discussed by Teddy Roosevelt in his famous quote: "Far better it is to dare mighty things, to win glorious triumphs, even though checkered by failure, than to take rank with those poor spirits who neither enjoy much nor suffer much, because they live in the gray twilight that knows not victory nor defeat."[2] Internal Auditors are still generally viewed as "tools of management", regardless of the attempts by the Institute of Internal Auditors (IIA) to insert Internal Auditing at the pinnacle of corporate governance. Even the IIA is currently sponsoring research on the nature of internal audit's role in another well-intended self-promotion effort.[3]

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[2] Speech before the Hamilton Club, Chicago, April 10, 1899
[3] Internal Audit Reporting Relationships – Serving Two Masters, The IIA Research Foundation (2003)

Additionally, none less than that bastion of corporate governance – the New York Stock Exchange - recently updated its listing standards to require an internal audit function for its listed companies.

However (comma) no one outside of (most) internal auditors knows exactly what it is that internal auditors are supposed to do – a game of pinball comes to mind for some reason.

The external audit profession's role has been hardened via the securities law and a recent dunking of the AICPA – not a good year for SRO's. Additionally, PCAOB is now looking to take a new hunk out of the collective hide of the remaining Final Four.

If, in fact, the concepts embodied in SAS 65 are to survive, the standard is in need of significant coordinated (IIA, ISACA) update to provide current context for the internal audit profession, which is currently hamstrung over the moat that exists between Board Audit Committees and the senior management group that signs its paycheck.

D. **<u>Incorporating Internal Audit Reports by Reference – Par. 191</u>** – The concept of incorporating by reference internal audit reports into the external auditor communications is a non-starter. Internal Audit does not follow the PCAOB standard and does not have a three tier control weakness identification system that ostensibly could be "piggybacked" under the proposed scheme. Internal Audit generally spends most of its time in the operational and IT areas, which is the core of a business, not the derived financial reporting area which is a low/no value proposition for internal auditors. The best internal audit shops do as little as possible in the area of external audit assistance as it is well known that the business risks do not live in this domain of the vaunted COSO cube.

See item C. regarding the coordinated update of SAS 65 language.

E. **<u>Impact of Restatements on Internal Control Opinions</u>** – The draft standard does not provide adequate guidance on restating internal reports to address the need to perform multi-period restatements for material financial statement errors. Assuming the goal is to have some sense of parallel, it would appear that each internal control report presented would have to be "restated" and reissued if and when needed.

Similar guidance should be provided with respect to quarterly reporting restatements vis a vis 302/404.

F. **Reliance on Internal Control in Performing a Financial Statement Audit** – as this pending standard will essentially blow a hole in the pre-existing financial statement audit model as it relates to internal control interaction with substantive testing decisions, additional detailed guidance should be provided via a de facto update of SAS 78 and other relevant guidance in the standard. The current guidance in paragraph 136 et al is wholly insufficient, as it does not address depth and breadth of assurance in this pivotal point of the integrated audit.

G. **SAS 70, Trust Services, Agreed-Upon Procedures, Other Internal Control Related (SSAE) Reports** – with a new requirement for an audit of internal control (however ultimately defined), the aforementioned AICPA artifacts have either been wholly or partly subsumed and / or made obsolete. To ensure some semblance of relevancy and reliability, the context for providing these services on an ongoing basis should be updated concurrent with the issuance of the new PCAOB standard. A simple example – does the SAS 70 Type I and Type II distinction sufficiently parallel the design and operational effectiveness language in the draft PCAOB? Paragraph B33 has a "do some stuff" feel in the event SAS 70 is not available – is this the intent?

H. **Requirement for Written Representations** – provide an example representation letter as an appendix to the standard. If this is not done, the representation letters may be longer than the documentation developed in support of the management assertion.

Paragraph 130. states "AU sec. 333, *Management Representations*, explains matters such as who should sign the letter, the period to be covered by the letter, and when to obtain an updating letter." At a minimum, update AU Sec. 333 or supplement in PCAOB to name the Chief Information Officer (or equivalent – the Principal Information Technology Officer) as a required signature for the representation letter. CEO and CFO generally do not have a specific competency in this area. With all of the focus on lawyers and their noisy withdrawals, consideration should also be given to requiring general counsel (or equivalent) signature as a standard.

PCAOB Questions for Comment – Selected Responses – "No comment" on the other items (excluded from the items listed below).

1. Is it appropriate to refer to the auditor's attestation of management's assessment of the effectiveness of internal control over financial reporting asthe audit of internal control over financial reporting?

Yes. The proposed scope change is so significant and so fundamental that there are now two (integrated) audits required for public companies on an annual basis. This fact should be reflected in the characterization of the scope of services.

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?

No. In fact, the guidance muddies the water. Just as the big company little company GAAP debate has carried on for years with no resolution, this is a similar topic. A well-written standard and considered professional judgment in the application and interpretation thereof are sufficient.

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 audit 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.

No. This is another Pandora's box topic. The next step might be overlaying government employee classifications on the public accounting profession's staffing model.

I believe that SAS 99 may contain guidance in this area on the issue of fraud.

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.

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

Yes. Reference is made to ISACA's October 2003 Discussion Paper – IT Control Objectives for Sarbanes-Oxley (www.isaca.org) - Page 28 **– How Compliance Should be Documented** section. Without going out on a limb or getting overly specific, the PCAOB standard should adopt a similar approach to that of ISACA – such guidance is generally expected in a "standard".

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 a significant deficiency or material weakness in internal control?

Yes. However, context must be clearer. See item 7 above.

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

The term "Walkthroughs" is so generic as to be almost meaningless, much like the term Gateway in the information technology world. Frankly, this lingo sounds like it came out of an academic who never engaged in the professional practice of auditing. Its current positioning over emphasizes the importance thereof and should be significantly toned down. Walkthroughs, however defined, are not a panacea and should be considered one element of a good start in understanding internal control.

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?

No. If a requirement is needed in this area, it would be much more logical to require management to document the 'walkthrough'. The control owner should be in a much better position to document the internal control process, much as a registrant prepares its own financial statements, which should then be tested by the auditor as part of the engagement.

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?

Yes. The world claims internal control is dynamic and ever changing, why permit reliance on stale information when defining this assurance service? Avoid the urge to backslide on this one.

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

To the same extent that Arthur Andersen should have been allowed to rely on the work of Scott Sullivan, Andy Fastow and the former Andersen employees at Waste Management. Who are you kidding???

As discussed above, Internal Audit currently lives in the gray twilight between management and the Board audit committee. Nonetheless, SAS 65 concepts should be updated and carried forward into the new standard if any forward progress is to be made in this bifurcated arena.

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 approach is broken. See comment 12.

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?

No. See comment 12. Additionally, there is no workable basis for tying 'other third parties' into the mix at this time. Keep it simple by focusing on modernizing standards guiding the interaction of external and internal auditors.

15. Is the flexibility in determining the extent of reperformance of the work ofothers 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)?

Yes. See comment 14 regarding adding additional clarity to the interaction of internal and external audit.

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?

Why is this question even being posed? There's only one firm signing that integrated audit report. The firm must be in full control of the nature, timing and extent of testing to be performed to accomplish the stated objective. Cleaning up the draft standard to determine what is allowable on the internal audit reliance front will assist the external auditor in this process.

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?

Reference an Internet quote - Work that some call “obscene” may be “art” to others. Justice Potter Stewart once said he couldn't define obscenity, but "I know it when I see it." The ambiguity of definition still exists and is becoming even more problematic with the Internet.”

The same situation exists with the shades of gray used to paint internal control “weaknesses”. Good luck on your current attempt.

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 the commenters could suggest that would provide further interpretive help?

See item 17.

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

How can the proposed three-tier classification scheme otherwise be complied with? See item 17.

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. The vehicle for such reporting should be clear because current management letter practices (for internal control deficiencies) are scattered and not all “weaknesses” (to be better defined by PCAOB) currently make their way from the working papers into the “management letter”, which will no longer be an optional deliverable. Additional guidance in the standard language is required. Perhaps a parallel can be drawn with SAS 61 and disclosure of ‘passed adjustments’ – this may even be considered as context for delivery of “Tier 3” weaknesses…

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?

No. Provision of such service is beyond the current competency of most auditing firms, creates a direct conflict with the Committee and is generally nonsensical. The listing standards and regulatory Charter requirements should guide efforts in this area. Consideration should be given to creating a checklist of audit committee best practices that would be completed by the Audit Committee, signed by the Audit Committee Chair and Chairman of the Board and filed as part of either the 10-K or the annual proxy statement. No need for a separate audit or attestation would be necessary.

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

See item 22.

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?

See item 22. Firms should follow their existing and soon to be revised practices to manage their risk with respect to audit committee effectiveness. Resignation with the resultant 8-K filing provides an adequate vehicle for raising issues in this area if and when needed.

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 internal control over financial reporting rather than to whether management's assessment is fairly stated?

See item 1.

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

Yes. There is such a billing bonanza and variety of services been driven into the existing client base right now, including establishing dependencies on the incumbent external audit firm. Registrants need to know as soon as possible if their existing arrangements violate independence standards so that new arrangements can be made on a timely basis to comply with the stringent pending deadlines.

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

See item 28.

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Public Company Accounting Oversight Board
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Re: PCAOB Rulemaking Docket Matter No. 008 – Potentially Perjurious Testimony by Ernst & Young at HealthSouth Congressional Hearing.

Dear Board Members:

Having been closely associated with individuals working on the HealthSouth audit it may be interesting to ask – would the procedures outlined in your proposed rules have helped the external auditor, Ernst & Young, in identifying this fraud. The answer is a simple no. To understand why that is one needs to understand that what happened at HealthSouth (and Enron and the other infamous audit failures) was not only an elaborate fraud but a significant failure of a financial audit by the auditors.

Obviously the profession does not want to admit that and will work hard to defend themselves against such acquisitions. The reality is – the audit failed. Looking more closely at HealthSouth may help to shed some light on this issue.

The Audit Procedures that Ernst & Young used in executing their audit of HealthSouth were deficient. They did not adhere to Generally Accepted Auditing Standards in performing the audit.

For example, their procedures around investigating internal controls ("Tone at the Top") were defective. Mr. Lamphron and Mr. Dunn, the Ernst & Young professionals, testified to congress that they relied on a procedure known in the trade as "Inquiry" when auditing (assessing) HealthSouth's control environment. They failed to receive any "corroborative evidence" when they reportedly asked the chief compliance officer, Kelly Cullison, about the nature of any reports and investigations conducted.

The SEC staff has noted that generally accepted auditing standards provides guidelines for how to evaluate the sufficiency, persuasiveness, and verifiability of evidential matter. In Statement on Auditing Standards No. 31, Evidential Matter specific guidance is provided for the purposes of evaluating the sufficiency, persuasiveness, and verifiability of evidence.

In their testimony to congress the audit partners described a situation whereby they interviewed one or two key members of the compliance group on potential frauds in a meeting on December 3rd. They seemed to suggest that no matter what they did they were in effect duped because the fraud existed at the highest levels within the HealthSouth organization. Taken on the surface these are great sound bites. The reality is – Ernst & Young did not perform sufficient procedures to understand the true nature of compliance activity. The quality of the audit was deficient.

Every first year auditor knows that inquiry alone is not a sufficient audit procedure. Inquiry in fact is the least persuasive form of evidentiary matter. They did not seek to review any of the report logs or even fully understand how matters were brought forward to the compliance group. Ernst & Young's evaluation of these "entity level" controls was defective. They did not sufficiently probe to even ascertain if the dismissive statement they received was credible.

A close examination of the facts might cause one to question the truthfulness of Ernst & Young's testimony.

Mr. Lamphron testified that he met with Kelly Cullison and/or Tony Tanner more then 50-100 times. This is not only highly unlikely – it is likely to be an intentionally misleading, or at the very least a *Clintonese* type statement to somehow suggest that his procedures were in fact appropriate. Had he met with either of these parties as much as he claimed and performed any sort of evidentiary procedure beyond a very basic inquiry then he very possibly might have identified the concerns raised by Diane Henze in 1999.

The Auditors lacked sufficient knowledge of the client's business system to effectively perform the audits.

The client had implemented a fairly complex accounting system. Ernst & Young was very involved in evaluating the controls and accounting functionality of this system. They even helped develop business procedures and accounting rules on how this system should be utilized. This work was done by a Ernst & Young audit professionals at enormous expense to HealthSouth. The audit partners suggested to management that these services were necessary in order for them to effectively perform future audits. They generated substantial fees from these engagements.

The ironic thing is – that much of the fraud that was perpetrated was done so using these systems for which their auditor helped design "effective" controls. The interesting thing is that although Ernst & Young apparently helped them design effective controls the financial auditors lacked a sufficient understanding of this system to effectively audit it. They could not effectively conduct tests (beyond an inquiry) of this system because they lacked the technical knowledge of how this system operated. Perhaps they mistakenly assumed that since their own organization was involved in assessing, evaluating and documenting the controls of this system, no additional test of details was needed.

This is a classic example of why the independent auditor should not be engaged to perform these types of services. There is a propensity to place undue reliance upon work performed by your own organization. After all how could the system be wrong when Ernst & Young collected over $288,500 (more then 25% of the total audit fees) in 2001 performing the "Oracle System Controls Assessment" for HealthSouth? After all weren't they engaged to make sure the system was right? The same holds true for the original accounting system which was placed into service in 1997.

Some might argue there is something more significant going on here, and that is that the auditors lack the technical competency to effectively conduct audits of their clients complex IT environments. Had the auditors had an appropriate understanding of the importance of these accounting systems to the overall activity that was being performed they would have (or should have) been able to design appropriate procedures to assess risk and perform an appropriate audit. This is something they clearly did not do at HealthSouth.

Individuals performing field level work did not have sufficient training and experience to conduct an effective audit.

According to existing regulations and professional standards that were in place prior to Sarbanes-Oxley, this fraud should have been detected. The Securities and Exchange Commission requires under the Securities Act, that audits of public companies must include "procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts." Accordingly, the provisions of SAS 53 and SAS 54 require auditors to have sufficient procedures and tests to effectively identify fraud that could be material to the financial statements.

The audit procedures used at HealthSouth were not sufficient in this regard. Clearly for a fraud of this magnitude to have occurred over a period of seven years one must assume that the audit itself was defective by design. Ernst & Young, and every other major accounting firm, should seriously scrutinize their existing methodologies, which, based on recent events, appear to be deficient. Not only was the approach deficient but many of the people performing the field work were not properly trained and supervised as they executed the tasks assigned to them.

There was pressure on the staff to perform activities within an aggressive budget dictated and controlled by the senior managers and partners on the engagement. This environment forced staff and senior auditors to ignore the sufficiency, adequacy, and completeness of their audit procedures and tests. Exceptions that occurred (which may have uncovered the fraud as early as 1997) were not pursued due to pressure from Managers and Senior Managers on the engagement to get work done on time and on budget. Staff and Seniors who went over budget or raised questions about the quality of the work were likely to receive lower performance ratings and/or were often transferred to other accounts or "counseled out" of The FIRM.

The pressure from Senior Partners to ignore potential issues was rampant and with good reason. Non-Audit Fees were more then 2X the audit fees. The Senior Partners spent time building deep personal relationships with the senior executives. The fact is they ignored their own team and spent very little of their actual time working on the engagement activities. Instead they spent (and charged time to the engagement) building personal relationships and entertaining the client executives. They wanted to affiliate themselves with some of Birmingham's most elite and admired power brokers. They did so at the expense of their own judgment, integrity, and team.

The congressional investigators should have interviewed former staff and seniors about the activities they performed relative to their superiors to get a real perspective of how inadequate and deficient the audit was. As much as they seemed to suggest that this account was very small and insignificant to the whole firm, anyone who worked in the Birmingham office knew this was a "flagship" account to work on. Again, the auditors demonstrate a pattern of misleading congress as they tried to suggest that this account was some how insignificant to the revenue of The Firm. They testified that this account was insignificant – yet much of their personal income was directly attributable to the success of this one account.

This Fraud was so massive the auditors should have discovered. Instead Ernst & Young, like their predecessor Andersen, made statements to Congress that are not entirely true.

Existing professional standards and existing regulations require auditors to develop procedures sufficient to uncover a fraud of this magnitude. The Ernst & Young Partner, Mr. Lamphron, testified at the Congressional hearings that they have taken corrective measure in response to the new "fraud standards" and regulations that have come out under Sarbanes-Oxley. They made a statement that they have conducted over "300,000" hours of fraud training for their employees. The implication being that these new standards are somehow going help prevent another audit failure.

There are two problems with these misleading, if not deliberately untruthful, statements. First of all, under existing professional standards there is and should be no reason that they missed this massive of a fraud except for one factor: the design and execution of their audit was deficient.

The second, and perhaps more incriminating problem with this statement, and their testimony, is that it is simply untrue. Again, they appear to be engaged in an Andersen like pattern of misleading congress. Ernst & Young has not conducted over 300,000 hours of fraud training for all of their auditors as Mr. Lamphron testified. Not only are they misrepresenting the facts they have plagiarized statements made by one of their competitors in this regard.

Earlier this year – executives from PriceWaterhouseCoopers (PWC) were quoted in the Wall Street Journal and print ads as saying that they were "undertaking an initiative" to train their auditors in fraud discovery techniques.

PWC claimed that they planned to provide fraud training in the neighborhood of 300,000 hours for some of their professional staff. Last I heard, EY and PWC have not formally merged. Yet, Mr. Lamphron testified to congress that they have actually performed that which their competitors intended to do. Perhaps these auditors are simply oblivious to the concept of truthfulness and accuracy whether that be in their testimony or in their client's financial statements.

The veracity of the Ernst & Young Partner's statements should be carefully examined. The Ernst & Young statements and testimony was not only highly deceptive – but it is simply untrue. Do the math. If they have 22,000 employees that would mean that every employee has gone through approximately 2 days (or 16 hours) of fraud training. This has not happened. This is a false and deliberately misleading statement. The fact that Ernst & Young is now defending itself by plagiarizing statements from their competition in a Congressional Hearing highlights just how corrupt the accounting profession has become.

In conclusion, it seems that although you have defined some rather broad and all encompassing rules. These rules are somewhat pointless if the auditors don't do their job and that is: audit the financial statements. The proposed standard is far too broad and far too reliant upon the work of inexperienced and unqualified audit professionals. Where is the boundary between sensible policymaking and unreasonable enforcement?

The proposed standard seems to suggest that a needless and senseless vaccine known as the documentation of internal controls can somehow cure all that ails our capital markets. This is absurd. The reality is quite clear – internal controls are far more complex and elusive. Documentation and testing of those controls by unqualified, inexperienced, and incompetent auditors is not and will not be an adequate prescription.

This will not help auditors identify and detect nefarious executives who are comfortable violating their own responsibilities for personal gain. Teresa Sanders, the former Chief Auditor of HealthSouth testified to Congress that when you have a collusive fraud at the senior levels of management it is very easy to defeat a financial statement audit. Why would an audit of internal controls as you have proposed be any different? It would not be and therein lays the problem with the proposed standard.

If the PCAOB is serious about implementing reform, then you should table these proposed rules until you can adequately address the reform that is truly needed. Rather then create a whole new opportunity for auditors to escape responsibility for performing an adequate audit you should instead focus on defining rules that would make financial audits more effective. Instead of burdening companies with bureaucratic requirements that provide little if any value or benefit – you should:

- Establish rules that require auditors to be completely independent of their audit clients. This might include placing restrictions on the firm's ability to hire-back or hire-out their professionals to their clients. (A common practice that causes serious issues/conflicts).

- Bar auditors from performing other lucrative services such as internal audit and system audits for their clients. This would include requiring the firms to disband their tax, legal, and other consulting practices from their audit business

- Ban auditors from entertaining their clients and ban clients from entertaining their auditors. As seen in the HealthSouth situation these close personal relationships caused the auditors to shelve their judgment for social advantage.

- Restrict auditors from assisting their clients in assessing, designing, developing internal control systems that they later need to rely upon to execute their audit. This obvious conflict impairs independence and undermines the entire purpose of your intended rules. Companies should engage other independent firms to assist in providing these services and/or do the work themselves internally.

- Table the impending rules until you have sufficient time to examine the other more serious issues that have contributed to failed audits.

Thank you for considering these observations and comments as you move forward in the rulemaking process. It is important that accounting reform take place. Unfortunately the proposed prescription may not be the right cure for today's ailment.

Sincerely,

Rose Mary Woods

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Yellow Corporation

November 21, 2003

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To Whom It May Concern:

After 45 days of reading and trying to determine how the proposed Auditing Standard will be implemented; I believe the standard needs to be more flexible. The concern is that more testing or evidence gathering may be performed then the independent auditor, the Audit Committee or company management determines is necessary. Performing testing or obtaining evidence only to meet a PCAOB requirement is something we should all try to avoid. The watch word should be "One size does not fit all". Broad guidelines are needed, and make us work out the detail process even as we ask for more guidance.

I will go into more detail using question eleven put the same holds true for walkthroughs, reliance on who did the work or when the work was done. Audit Committees have been significantly upgraded. If there is a difference of opinion between the independent auditor and the company the Audit Committee should have the responsibility to resolve the difference.

<u>Question Eleven:</u>

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?

The independent auditor should have the flexibility to rely on his or her judgment as to when previous years can be used to support a current opinion. There are high volume routine transactions that are significant to the financial statements but the process does not change from year to year. An example may be accounts payable, fixed assets, cash application and payroll. These areas are significant but may not change from year to year. These are also areas where period to period and year to year comparisons are made to monitor budgets and business forecasts. When to test the application or how and if to gather evidence should be left to the judgment of the auditor based on pervasive controls, the extent of the monitoring and other factors she or he may want to consider.

It is highly unlikely that a material misstatement will be found testing high volume routine transactions. These are computer applications and if one is wrong they are all wrong and that will be noticed.

As you are aware, material misstatements are more likely to occur in judgment areas like reserves and accruals and that is where the testing is needed each year.

It is very likely that there will be situations where the auditor can and should rely on evidence obtained in previous years to support his or her current opinion and they should have the flexibility to do that.

Question Twenty-three:

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

No. You should get agreement on this question from the independent auditor, the company and the audit committee. The independent auditor is not present at the Board meetings or in the private meetings with management and that is where the effectiveness is determined. The auditor can determine the qualifications of the members but not their effectiveness. There is also the conflict of working for the committee and than evaluating their effectiveness.

The effectiveness of the audit committee is a Board matter.

Sincerely,

Gary Mielke
Director Audit

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AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS	PCAOB Release No. 2004-001 March 9, 2004 PCAOB Rulemaking Docket Matter No. 008

Summary: After public comment, the Public Company Accounting Oversight Board (the "Board" or "PCAOB") has adopted Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements. This standard is the standard on attestation engagements referred to in Section 404(b) as well as Section 103(a)(2)(A) of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act" or "the Act"). The Board will submit this standard to the Securities and Exchange Commission ("Commission" or "SEC") for approval pursuant to Section 107 of the Sarbanes-Oxley Act of 2002 (the "Act"). This standard will not take effect unless approved by the Commission.

Board
Contacts: Thomas Ray, Deputy Chief Auditor (202/207-9112; rayt@pcaobus.org), Laura Phillips, Associate Chief Auditor (202/207-9111; phillipsl@pcaobus.org).

* * *

The series of business failures that began with Enron in late 2001 exposed serious weaknesses in the system of checks and balances that were intended to protect the interests of shareholders, pension beneficiaries and employees of public companies – and to protect the confidence of the American public in the stability and fairness of U.S. capital markets.

RELEASE

From the boardroom to the executive suite, to the offices of accountants and lawyers, the historic gatekeepers of this confidence were found missing or, worse, complicit in the breaches of the public trust.

Congress responded to the corporate failures with the Sarbanes-Oxley Act of 2002, creating a broad, new oversight regime for auditors of public companies while prescribing specific steps to address specific failures and codifying the responsibilities of corporate executives, corporate directors, lawyers and accountants.

The merits, benefits, cost and wisdom of each of the prescriptions can and will fuel debate. But the context for the passage of the Sarbanes-Oxley Act, and the President's signing it into law on July 30, 2002, cannot be ignored: Corporate leaders and advisors failed. People lost their livelihoods and their life savings. The faith of America and the world in U.S. markets was shaken to the core.

In that context, the PCAOB adopted the standard for auditors to use when assessing whether managers of a public company have accurately reported on companies' internal controls over financial reporting.

Failures in internal control, particularly over financial reporting, were among the specific concerns addressed by Congress in the Sarbanes-Oxley Act. Congress required not just that management report on a company's internal control over financial reporting, but that auditors attest to the accuracy of management's report.

The bottom line for Congress, and for the PCAOB, is the reliability of the company's financial statements – statements relied on by shareholders, management, directors, regulators, lenders, investors and the market at large.

To achieve reliable financial statements, internal controls must be in place to see that records accurately and fairly reflect transactions in and dispositions of a company's assets; to provide assurance that the records of transactions are sufficient to prepare financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures are made only as authorized by management and directors; and to make sure that steps are in place to prevent or detect theft, unauthorized use or disposition of the company's assets of a value that could have a material effect on the financial statements.

RELEASE

In the simplest terms, investors can have much more confidence in the reliability of a corporate financial statement if corporate management demonstrates that it exercises adequate internal control over bookkeeping, the sufficiency of books and records for the preparation of accurate financial statements, adherence to rules about the use of company assets and the possibility of misappropriation of company assets.

The Sarbanes-Oxley Act, in Section 404, requires company management to assess and report on the company's internal control. It also requires a company's independent, outside auditors to issue an "attestation" to management's assessment – in other words, to provide shareholders and the public at large with an independent reason to rely on management's description of the company's internal control over financial reporting.

Reliable financial reporting is too important to relegate an auditor's attestation to a rubber-stamped endorsement of management's report on internal controls. As a result, the PCAOB is requiring that auditors perform an audit of internal control over financial reporting and to perform that audit in conjunction with the audit of a company's financial statements.

The one audit cannot be separated from the other. The information the auditor learns as a result of auditing the company's financial statements has a direct and important bearing on the auditor's conclusion about the effectiveness of the company's internal control over financial reporting.

Section 404 and the Board's requirements will entail extra work and, for companies, extra expense, particularly in the first year of implementation. The PCAOB will be vigilant in its inspections of accounting firms and conversations with issuers, particularly small and medium-sized companies, to see that expense isn't increased for its own sake.

The Board does not underestimate the demands this auditing standard will impose on auditors and public companies. But in the end, the Board, public companies and the accounting profession answer to the higher demand of accuracy, reliability and fairness in the financial statements that provide the basis for trust in our financial markets.

RELEASE

A. The Benefits of Effective Internal Control Over Financial Reporting

Companies use internal controls as checks on a variety of processes, including financial reporting, operating efficiency and effectiveness, and compliance with applicable laws and regulations. The Sarbanes-Oxley Act focuses on companies' internal control over financial reporting.

Internal control over financial reporting consists of company policies and procedures that are designed and operated to provide reasonable assurance about the reliability of a company's financial reporting and its process for preparing and fairly presenting financial statements in accordance with generally accepted accounting principles. It includes policies and procedures for maintaining accounting records, authorizing receipts and disbursements, and the safeguarding of assets.

Effective internal control over financial reporting is essential for a company to effectively manage its affairs and to fulfill its obligation to its investors. A company's management, its owners – public investors – and others must be able to rely on the financial information reported by companies to make decisions.

Strong internal controls also provide better opportunities to detect and deter fraud. For example, many frauds resulting in financial statement restatement relied upon the ability of management to exploit weaknesses in internal control. To the extent that internal control reporting can help restore investor confidence by improving the effectiveness of internal controls (and reducing the incidence of fraud), assessments of internal controls over financial reporting should emphasize controls that prevent or detect errors as well as fraud.

Evaluating a company's internal control over financial reporting is not without cost, but it provides many far-reaching benefits. Regular assessments, and reporting on those assessments, can help management develop, maintain and improve existing internal control. Assessments can identify cost-ineffective procedures, reduce costs of processing accounting information, increase productivity of the company's financial function, and simplify financial control systems. It also may result in fewer financial statement restatements and less litigation.

The primary benefit of evaluations, however, is to provide the company, its management, its board and audit committee, and its owners and other stakeholders with a reasonable basis on which to rely on the company's financial reporting. The integrity of financial reporting represents the foundation upon which this country's public markets are built.

As with many endeavors, internal control over financial reporting is a process that involves human diligence and compliance and, consequently, can be intentionally circumvented. As a result, no system of internal control over financial reporting, regardless of how well it is designed and operating, can provide absolute assurance that a company's financial statements are accurate.

Nevertheless, as companies develop processes to assist management in assessing internal control and as auditors perform their evaluations, the assessment process should result in a continuous strengthening of internal control over financial reporting.

B. Basis for Internal Control Reporting and the Board's Standard

Section 404(a) of the Sarbanes-Oxley Act requires the management of a public company to assess the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year and to include in the company's annual report to shareholders management's conclusion, as a result of that assessment, about whether the company's internal control is effective. The SEC implemented Section 404(a) in a rule on June 5, 2003.[1/]

Section 404(b) of the Act requires the company's auditor to attest to and report on the assessment made by the company's management. Sections 103(a)(2)(A) and 404(b) of the Act direct the PCAOB to establish professional standards governing the independent auditor's attestation.

In April 2003, the Board adopted pre-existing professional standards as the Board's interim standards, including a standard governing an auditor's attestation on internal control. Mindful of the requirements of the Sarbanes-Oxley Act and the need to evaluate the pre-existing standard, the Board convened a public roundtable discussion

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1/ See Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities and Exchange Commission Release No. 33-8238 (June 5, 2003) [68 FR 36636].

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on July 29, 2003, to discuss issues and hear views related to reporting on internal control. The participants included representatives from public companies, accounting firms, investor groups, and regulatory organizations.

As a result of comments made at the roundtable, advice from the Board's staff, and other input, the Board determined that the pre-existing standard governing an auditor's attestation on internal control was insufficient for purposes of effectively implementing the requirements of Section 404(b) of the Act and for the Board to appropriately discharge the Board's standard-setting obligations under Section 103 of the Act. In response, the Board developed and issued, on October 7, 2003, a proposed auditing standard titled "An Audit of Internal Control over Financial Reporting in Conjunction with An Audit of Financial Statements."

The Board received 193 comment letters from a variety of interested parties, including auditors, investors, internal auditors, issuers, regulators, and others on a broad array of topics. Those comments led to changes in the proposed standard, intended to make the requirements of the standard clearer and more operational.

The Board has approved PCAOB Auditing Standard No. 2, implementing the requirements of the Sarbanes-Oxley Act and incorporating comments received.

This release summarizes the process involved in conducting an audit of internal control over financial reporting, other significant provisions of PCAOB Auditing Standard No. 2 and some of the significant considerations of the Board when it initially proposed this standard and when it evaluated the comments it received. The Board's detailed analysis of the comments received and the Board's responses are contained in Appendix E to the standard.

C. The Audit of Internal Control Over Financial Reporting

In preparing PCAOB Auditing Standard No. 2, the Board was guided by a number of broad considerations that have effect throughout the standard. Those broad considerations included: that "attestation" is insufficient to describe the process of assessing management's report on internal controls; that an audit of internal control over financial reporting must be integrated with an audit of the company's financial statements; and that the costs of the internal control audit be appropriate in consideration of the expected benefits to investors of improved internal control over financial reporting.

D. Attestation vs. Audit

Throughout Auditing Standard No. 2, the auditor's attestation of management's assessment of the effectiveness of internal control is referred to as the audit of internal control over financial reporting. The Board has noted, in comment letters and in other communications, that some people have drawn a distinction between an "audit" and an "attestation," suggesting that an attestation is a different type of engagement that involves a lesser amount of work than an audit. This idea is erroneous. An attestation engagement to examine management's assessment of internal control requires the same level of work as an audit of internal control over financial reporting.

The objective of an audit of internal control over financial reporting is to form an opinion "as to whether management's assessment of the effectiveness of the registrant's internal control over financial reporting is fairly stated in all material respects."[2/] Further, Section 103(a)(2)(A)(iii) of the Act requires the auditor's report to present an evaluation of whether the internal control structure provides reasonable assurance that transactions are recorded as necessary, among other requirements.

Importantly, the auditor's conclusion will pertain directly to whether the auditor can agree with management that internal control is effective, not just to the adequacy of management's process for determining whether internal control is effective.

An auditing process restricted to evaluating what management has done would not provide the auditor with a sufficiently high level of assurance that management's conclusion is correct. The auditor needs to evaluate management's assessment process to be satisfied that management has an appropriate basis for its conclusion. The auditor, however, also needs to test the effectiveness of internal control to be satisfied that management's conclusion is correct and, therefore, fairly stated. Indeed, as the Board heard at the internal control roundtable and in comment letters, investors expect the independent auditor to test whether the company's internal control over financial reporting is effective, and Auditing Standard No. 2 requires the auditor to do so.

[2/] See SEC Regulation S-X 2-02(f), 17 C.F.R. 210.2-02(f).

E. Integrated Audit

PCAOB Auditing Standard No. 2 describes an integrated audit of the financial statements and internal control over financial reporting. Accordingly, it is an integrated standard that (1) addresses both the work that is required to audit internal control over financial reporting and the relationship of that audit to the audit of the financial statements and (2) refers to the attestation of management's assessment of the effectiveness of the internal control as the audit of internal control over financial reporting.

The Board decided that these audits should be integrated because the objectives of, and work involved in performing, an audit of internal control over financial reporting and an audit of the financial statements are closely related. Furthermore, Section 404(b) of the Sarbanes-Oxley Act provides that the auditor's attestation of management's assessment of internal control shall not be the subject of a separate engagement.

Each audit provides the auditor with information relevant to the auditor's evaluation of the results of the other audit. For example, the auditor's discovery of misstatements in the financial statements while performing financial statement auditing procedures indicates that there may be weaknesses in the company's internal control over financial reporting. Because of the significance of this interrelationship, the Board has made it clear that, to conduct and report on the results of an audit of internal control over financial reporting pursuant to Auditing Standard No. 2, the auditor also must audit the company's financial statements.

Notwithstanding the fact that the two audits are interrelated, the integrated audit results in two separate objectives: to express an opinion on management's assessment of the effectiveness of the company's internal control over financial reporting and to express an opinion on whether the financial statements are fairly stated.

F. Cost

The Board is sensitive to the costs Section 404 and Auditing Standard No. 2 may impose on all companies, particularly some small and medium-sized companies. The

Board anticipates that most companies of all sizes will experience the highest cost of complying with Section 404 during the first year of implementation.

Internal control is not "one-size-fits-all," and the nature and extent of controls that are necessary depend, to a great extent, on the size and complexity of the company. Large, complex, multi-national companies, for example, are likely to need extensive and sophisticated internal control systems.

In smaller companies, or in companies with less complex operations, the ethical behavior and core values of a senior management group that is directly involved in daily interactions with both internal and external parties might reduce the need for elaborate internal control systems. The Board expects that the auditor will exercise reasonable professional judgment in determining the extent of the audit of internal control and perform only those tests that are necessary to ascertain the effectiveness of the company's internal control.

Management is required to base its assessment of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework established by a body of experts that followed due-process procedures to develop the framework. In the United States, the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission has published Internal Control – Integrated Framework. COSO's publication (also referred to simply as COSO) provides a suitable framework for purposes of management's assessment.

The directions in Auditing Standard No. 2 are based on the internal control framework established by COSO because of the frequency with which management of public companies are expected to use that framework for their assessments. Other suitable frameworks have been published in other countries and likely will be published in the future. Although different frameworks may not contain exactly the same elements as COSO, they should have elements that encompass all of COSO's general themes. The auditor should therefore be able to apply the concepts and guidance in Auditing Standard No. 2 in a reasonable manner if management uses a suitable framework other than COSO.

The Board believes that the special considerations for small and medium-sized companies included within COSO provide well for the auditor's use of such judgment, more so than the appendix that the Board's proposed standard originally included. For this reason, the proposed appendix was removed from Auditing Standard No. 2 and replaced with a direct reference to the special considerations within COSO.

The Board also was cognizant of audit costs in its consideration of the appropriate extent to which the auditor may use the work of internal auditors and others to support the auditor's opinion on internal control effectiveness. Auditing Standard No. 2 provides the auditor with significant flexibility in using the relevant work of highly competent and objective personnel, while also requiring the auditor to obtain through his or her own auditing procedures a meaningful portion of the evidence that supports the auditor's opinion. The Board believes it has achieved an appropriate balance of work between the auditor and others that will ensure a high quality audit of internal control and that have the complementary benefit of encouraging companies to invest in competent and objective internal audit functions.

G. The Audit Process

An audit of internal control over financial reporting is an extensive process involving several steps, including planning the audit, evaluating the process management used to perform its assessment of internal control effectiveness, obtaining an understanding of the internal control, evaluating the effectiveness of both the design and operation of the internal control, and forming an opinion about whether internal control over financial reporting is effective.

The auditor's objective is to express an opinion about whether management's assessment, or conclusion, on the effectiveness of internal control over financial reporting is stated fairly, in all material respects. To support his or her opinion, the auditor must obtain evidence about whether internal control over financial reporting is effective. The auditor obtains this evidence in several ways, including evaluating and testing management's assessment process; evaluating and testing work on internal control performed by others, such as internal auditors; and testing the effectiveness of the controls himself or herself.

H. Auditor Independence

The Sarbanes-Oxley Act, and the SEC rules implementing Section 404(a) of the Act, require the auditor to be independent to perform an audit of internal control over financial reporting. Under the SEC's Rule 2-01 on auditor independence, an auditor

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impairs his or her independence if the auditor audits his or her own work, including any work on designing or implementing an audit client's internal control system. PCAOB Auditing Standard No. 2 explicitly prohibits the auditor from accepting an engagement to provide an audit client with an internal control-related service that has not been specifically pre-approved by the audit committee. That is, the audit committee cannot pre-approve internal control-related services as a category, but must approve each service.

I. Key Provisions of Audit Standard No. 2

1. Evaluating Management's Assessment

The natural starting place for the audit of a company's internal control over financial reporting is management's assessment. By evaluating management's assessment, an auditor can have confidence that management has a basis for expressing its conclusion on the effectiveness of internal control. Such an evaluation also provides information that will help the auditor understand the company's internal control, helps the auditor plan the work necessary to complete the audit, and provides some of the evidence the auditor will use to support his or her opinion.

The work that management performs in connection with its assessment can have a significant effect on the nature, timing, and extent of the work the independent auditor will need to perform. Auditing Standard No. 2 allows the auditor to use, to a reasonable degree, the work performed by others. The more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be.

Also, the more clearly management documents its internal control over financial reporting, the process used to assess the effectiveness of the internal control, and the results of that process, the easier it will be for the auditor to understand the internal control, confirm that understanding, evaluate management's assessment, and plan and perform the audit of internal control over financial reporting. This too should translate into reduced professional fees for the audit of internal control over financial reporting.

2. Obtaining an Understanding of Internal Control Over Financial Reporting, Including Performing Walkthroughs

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The auditor should understand how internal control over financial reporting is designed and operates to evaluate and test its effectiveness. The auditor obtains a substantial amount of this understanding when evaluating management's assessment process.

The auditor also should be satisfied, however, that the controls actually have been implemented and are operating as designed. Thus, while inquiry of company personnel and a review of management's assessment process provide the auditor with an understanding of how the system of internal control is designed and operates, they are insufficient by themselves. Other procedures are necessary for the auditor to confirm his or her understanding.

Auditing Standard No. 2 directs the auditor to confirm his or her understanding by performing procedures that include making inquiries of and observing the personnel who actually perform the controls; reviewing documents that are used in, and that result from, the application of the controls; and comparing supporting documents (for example, sales invoices, contracts, and bills of lading) to the accounting records.

The most effective means of accomplishing this objective is for the auditor to perform "walkthroughs" of the company's significant processes. To introduce a powerful efficiency, and because of the importance of several other objectives that walkthroughs accomplish, Auditing Standard No. 2 requires the auditor to perform walkthroughs in each annual audit of internal control over financial reporting.

In a walkthrough, the auditor traces a transaction from each major class of transactions from origination, through the company's accounting and information systems and financial report preparation processes, to it being reported in the company's financial statements. Walkthroughs provide the auditor with audit evidence that supports or refutes his or her understanding of the process flow of transactions, the design of controls, and whether controls are in operation. Walkthroughs also help the auditor to determine whether his or her understanding is complete and provide information necessary for the auditor to evaluate the effectiveness of the design of the internal control over financial reporting.

Because of the judgment that a walkthrough requires and the significance of the objectives that walkthroughs allow the auditor to achieve, Auditing Standard No. 2 requires the auditor to perform the walkthroughs himself or herself. In other words, Auditing Standard No. 2 does not allow the auditor to use the work performed by management or others to satisfy the requirement to perform walkthroughs. However, to provide additional evidence, the auditor may also review walkthroughs that have been performed and documented by others.

The walkthroughs also must be done in each annual audit of internal control over financial reporting. Important objectives of walkthroughs are to confirm that the auditor's understanding of the controls is correct and complete. Without actually "walking" transactions through the significant processes each year, there is too high a risk that changes to the processes would go undetected by the auditor.

Because of the significance of the objectives they are intended to achieve, and the judgment necessary to their effective performance, walkthroughs should be performed by appropriately experienced auditors. Inexperienced audit personnel who participate in walkthroughs should be supervised closely so that the conditions encountered in the walkthroughs are considered appropriately and that the information obtained in the walkthroughs is appropriately documented.

3. Identifying Significant Accounts and Relevant Assertions

As a part of obtaining an understanding of internal control, the auditor also determines which controls should be tested, either by the auditor, management, or others. Auditing Standard No. 2 requires that the auditor obtain evidence about the operating effectiveness of internal control over financial reporting for all relevant assertions for all significant accounts or disclosures. This requirement relies heavily on two concepts: significant account and relevant assertion.

Auditing standards implicitly recognize that some accounts are more significant than others. Auditing Standard No. 2 provides additional direction on how to determine significant accounts for purposes of the audit of internal control over financial reporting. In short, the auditor begins by performing a quantitative evaluation of accounts at the financial-statement caption or note-disclosure level. Then the auditor expands the evaluation to include qualitative factors, such as differing risks, company organization structure, and other factors, which would likely result in additional accounts being identified as significant.

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Financial statement amounts and disclosures embody financial statement assertions. Does the asset exist, or did the transaction occur? Has the company included all loans outstanding in its loans payable account? Have marketable investments been valued properly? Does the company have the rights to the accounts receivable, and are the loans payable the proper obligation of the company? Are the amounts in the financial statements appropriately presented, and is there adequate disclosure about them? Answering these questions helps the auditor to identify the relevant financial statement assertions for which the company should have controls.

Identifying "relevant" assertions is a familiar process for experienced auditors, and because of the importance relevant assertions play in the required extent of testing, Auditing Standard No. 2 provides additional direction.

Similarly, experienced auditors are familiar with identifying significant processes and major classes of transactions. Major classes of transactions are those groupings of transactions that are significant to the company's financial statements. For example, at a company for which sales may be initiated by customers through personal contract in a retail store or electronically using the Internet, these would be two major classes of transactions within the sales process (if they were both significant to the company's financial statements). Because of the importance of significant processes and major classes of transaction in the design of the auditor's procedures, Auditing Standard No. 2 provides additional direction here, too.

4. Testing and Evaluating the Effectiveness of the Design of Controls

To be effective, internal controls must be designed properly, and all the controls necessary to provide reasonable assurance about the fairness of a company's financial statements should be in place and performed by appropriately qualified people who have the authority to implement them. At some point during the internal control audit, the auditor will need to make a determination as to whether the controls would be effective if they were operated as designed, and whether all the necessary controls are in place. This is known as design effectiveness.

The procedures the auditor performs to test and evaluate design effectiveness include inquiries of company personnel, observation of internal controls, walkthroughs, and a specific evaluation of whether the controls are likely to prevent or detect financial statement misstatements if they operate as designed. Auditing Standard No. 2 adopts these methods of testing and evaluating design effectiveness. The last step is especially important because it calls for the auditor to apply professional judgment and knowledge of and experience with internal control over financial reporting to his or her understanding of the company's controls.

5. Testing Operating Effectiveness

Auditing Standard No. 2 requires the auditor to obtain evidence about the operating effectiveness of controls related to all relevant financial statement assertions for all significant accounts and disclosures in the financial statements.

For this reason, in addition to being satisfied as to the effectiveness of the design of the internal controls, the auditor performs tests of controls to obtain evidence about the operating effectiveness of the controls. These tests include a mix of inquiries of appropriate company personnel, inspection of relevant documentation, such as sales orders and invoices, observation of the controls in operation, and reperformance of the application of the control.

Auditing Standard No. 2 directs required tests of controls to "relevant assertions" rather than to "significant controls." To comply with the requirements of Auditing Standard No. 2, the auditor would apply tests to those controls that are important to fairly presenting each relevant assertion in the financial statements. It is neither necessary to test all controls nor is it necessary to test redundant controls (unless redundancy is itself a control objective, as in the case of certain computer controls). However, the emphasis is better placed on addressing relevant assertions (because those are the points where misstatements could occur) rather than significant controls. This emphasis encourages the auditor to identify and test controls that address the primary areas where misstatements could occur, yet limits the auditor's work to the necessary controls.

Expressing the extent of testing in this manner also resolves the issue of the extent of testing from year to year (the "rotating tests of controls" issue). Auditing Standard No. 2 states that the auditor should vary testing from year to year, both to introduce unpredictability into the testing and to respond to changes at the company. However, each year's audit must stand on its own. Therefore, the auditor must obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year.

At the Board's roundtable, public company representatives and auditors indicated that providing examples of extent-of-testing decisions would be helpful. The proposed auditing standard included several examples, which have been retained in Appendix B of Auditing Standard No. 2.

6. Timing of Testing

The Act requires management's assessment and the auditor's opinion to address whether internal control was effective as of the end of the company's most recent fiscal year, in other words, as of a point-in-time. Performing all of the testing on December 31 is neither practical nor appropriate, however. To form a basis to express an opinion about whether internal control was effective as of a point in time requires the auditor to obtain evidence that the internal control operated effectively over an appropriate period of time. Auditing Standard No. 2 recognizes this and allows the auditor to obtain evidence about operating effectiveness at different times throughout the year, provided that the auditor updates those tests or obtains other evidence that the controls still operated effectively at the end of the company's fiscal year.

7. Using the Work of Others

The auditor must consider other relevant and available information about internal control when evaluating internal control effectiveness. In this regard, Auditing Standard No. 2 requires the auditor to understand the results of procedures performed by others, for example, internal auditors, other company personnel, and third parties working under the direction of management, on internal control over financial reporting.

At a minimum, the auditor should consider the results of those tests in designing the audit approach and ultimately in forming an opinion on the effectiveness of internal control over financial reporting. To this end, Auditing Standard No. 2 requires the auditor to review all reports issued during the year by internal audit (or similar functions, such as loan review in a financial institution) that address internal controls over financial reporting and evaluate any internal control deficiencies identified in those reports.

Additionally, the auditor may use the results of testing by others to alter the nature, timing, and extent of his or her tests of controls. At the Board's roundtable and in comment letters, public companies indicated their concern that at some point, the

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Board's standard could require an excessive amount of retesting by the auditor in order to use the work of others, especially internal auditors, and would inappropriately restrict the auditor's ability to use the work of internal auditors and others.

Public companies were particularly sensitive to this issue because of its direct bearing on the cost of complying with Section 404. On the other hand, the federal bank regulators indicated that experience with the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), which requires internal control reporting similar to Section 404 of the Act, revealed instances in which the auditor used the work of internal auditors to an inappropriately high degree, where the auditor himself or herself did not perform sufficient work to provide a reasonable basis for his or her opinion.

The directions in Auditing Standard No. 2 for using the work of others are based on the same concepts as Statement on Auditing Standards ("SAS") No. 65, Auditor's Consideration of the Internal Audit Function in an Audit of the Financial Statements.[3/] However, because the subject matter in an audit of internal control – the effectiveness of the controls – is different from the subject matter in an audit of financial statements – the reliability of the financial amounts and disclosures – some adaptation of SAS No. 65 was required.

The competence and objectivity factors described in SAS No. 65 were adapted to the evaluation of persons other than internal auditors, such as members of financial management, and the evaluation of the nature of the items tested by others was adapted to the context of an audit of internal control over financial reporting rather than an audit of financial statements. Additionally, Auditing Standard No. 2 creates an overall boundary on the use of the work of others in an audit of internal control over financial reporting not contained in SAS No. 65 by requiring that the auditor's own work provide the principal evidence for the audit opinion.

Auditing Standard No. 2 describes an evaluation process, focusing on the nature of the controls subject to the work of others and the competence and objectivity of the

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[3/] The Board adopted the generally accepted auditing standards, as described in the American Institute of Certified Public Accountants' ("AICPA") Auditing Standards Board's ("ASB") SAS No. 95, *Generally Accepted Auditing Standards*, as in existence on April 16, 2003, on an initial, transitional basis. SAS No. 65 is one of those standards.

persons who performed the work, that the auditor should use in determining the extent to which he or she may use the work of others.

For example, based on the nature of the controls in the control environment, the auditor should not use the work of others to reduce the amount of work he or she performs on the control environment. On the other hand, the auditor could use the work of others to test controls over the period-end financial reporting process. However, given the nature of these controls, the auditor would normally determine that he or she should perform more of these tests himself or herself, and that for any of the work of others the auditor used, the degree of competence and objectivity of the individuals performing the work should be high. Therefore, the auditor might use the work of internal auditors in this area to some degree but not the work of others within the company. Because of the importance of these decisions, Auditing Standard No. 2 provides additional direction.

Auditing Standard No. 2 also requires that, on an overall basis, the auditor's own work must provide the principal evidence for the audit opinion. Because the amount of work related to obtaining sufficient evidence to support an opinion about the effectiveness of controls is not susceptible to precise measurement, the auditor's judgment as to whether he or she has obtained the principal evidence for the opinion will be qualitative as well as quantitative. For example, the auditor might give more weight to work performed on pervasive controls and in areas such as the control environment than on other controls such as controls over routine, low-risk transactions. Also, the work the auditor performs in the control environment and walkthroughs provide an important part of the principal evidence the auditor needs to obtain.

These principles interact to provide the auditor with considerable flexibility in using the work of others and also prevent inappropriate over-reliance on the work of others. Although Auditing Standard No. 2 requires that the auditor reperform some of the tests performed by others in order to use their work, it does not set any specific requirement on the extent of the reperformance. For example, the standard does not require that the auditor reperform tests of controls over all significant accounts for which the auditor uses the work of others. Rather, Auditing Standard No. 2 relies on the auditor's judgment, such that the re-testing is sufficient to enable the auditor to evaluate the quality and effectiveness of the work.

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This considerable flexibility in using the work of others should translate into a strong encouragement for companies to develop high-quality internal audit, compliance, and other such functions. The more highly competent and objective these functions are, and the more thorough their testing, the more the auditor will be able to use their work.

8. Evaluating the Results of Testing

Both management and the auditor may identify deficiencies in internal control over financial reporting. A control deficiency exists when the design or operation of a control does not allow the company's management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

Auditing Standard No. 2 requires the auditor to evaluate the severity of all identified control deficiencies because such deficiencies can have an effect on the auditor's overall conclusion about whether internal control is effective. The auditor also has a responsibility to make sure that certain parties, such as the audit committee, are aware of control deficiencies that rise to a certain level of severity.

Under Auditing Standard No. 2, a control deficiency (or a combination of internal control deficiencies) should be classified as a significant deficiency if, by itself or in combination with other control deficiencies, it results in more than a remote likelihood of a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected. A significant deficiency should be classified as a material weakness if, by itself or in combination with other control deficiencies, it results in more than a remote likelihood that a material misstatement in the company's annual or interim financial statements will not be prevented or detected.

The definitions of significant deficiency and material weakness focus on likelihood and magnitude as the framework for evaluating deficiencies. The Board anticipates that this framework will bring increased consistency to these evaluations yet preserve an appropriate degree of judgment. Additionally, Auditing Standard No. 2 includes examples of how these definitions would be applied in several different scenarios.

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Auditing Standard No. 2 requires the auditor to communicate in writing to the company's audit committee all significant deficiencies and material weaknesses of which the auditor is aware. The auditor also is required to communicate to the company's management, in writing, all control deficiencies of which he or she is aware that have not previously been communicated in writing to management and to notify the audit committee that such communication has been made.

9. Identifying Significant Deficiencies

Auditing Standard No. 2 identifies a number of circumstances that, because of their likely significant negative effect on internal control over financial reporting, are significant deficiencies as well as strong indicators that a material weakness exists, including –

- Ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee. Effective oversight by the company's board of directors, including its audit committee, is essential to the company's achievement of its objectives and is an integral part of a company's monitoring of internal control. In addition to requiring the audit committee to oversee the company's external financial reporting and internal control over financial reporting, the Act makes the audit committee directly responsible for the appointment, compensation, and oversight of the work of the auditor. Thus, an ineffective audit committee can have detrimental effects on the company and its internal control over financial reporting, as well as on the independent audit. Auditing Standard No. 2 requires that, as part of evaluating the control environment and monitoring components of internal control, the auditor assess the effectiveness of the audit committee's oversight of the external financial reporting process and internal control over financial reporting.

  To be sure, the company's board of directors is responsible for evaluating the performance and effectiveness of the audit committee. Auditing Standard No. 2 does not suggest that the auditor is responsible for performing a separate and distinct evaluation of the audit committee. If the auditor concludes that oversight by the audit committee is ineffective, however, the auditor must communicate that specific significant deficiency, or material weakness as the case may be, in writing to the board of directors.

Normally, the auditor's interests and the audit committee's interests will be aligned: both should be interested in fairly presented financial statements, effective internal control over financial reporting, and an effective audit process. The Board recognizes that a theoretical conflict of interest results from the audit committee's responsibility to hire and fire the auditor. However, this type of conflict is one that experienced auditors are accustomed to bearing and that investors expect an auditor to address: when the auditor determines that its overseer is ineffective (which significantly impairs the effectiveness of the financial reporting process), the auditor must speak up.

- Material misstatement in the financial statements not initially identified by the company's internal controls. As previously stated, the audit of internal control over financial reporting and the audit of the company's financial statements are an integrated activity and are required by the Act to be a single engagement. The results of the work performed in a financial statement audit provide evidence to support the auditor's conclusions on the effectiveness of internal control, and vice-versa. Therefore, if the auditor discovers a material misstatement in the financial statements as a part of the audit of the financial statements, the auditor should consider whether internal control over financial reporting is effective. That the company's internal controls did not first detect the misstatement is, therefore, a strong indicator that the company's internal control over financial reporting is ineffective.

  Timing might be a concern for some issuers, particularly as it relates to making preliminary drafts of the financial statements available to the auditor. However, changes to the financial statement preparation process that increase the likelihood that the financial information is correct prior to providing it to the auditors likely will result in an improved control environment. The auditor also must exercise judgment when performing this evaluation. For example, if the auditor initially identified a material misstatement in the financial statements but, given the circumstances, determined that management would have found the misstatement on a timely basis before the financial statements were made publicly available, the auditor might appropriately determine that the circumstance was a significant deficiency but not a material weakness.

- Significant deficiencies that have been communicated to management and the audit committee, but that remain uncorrected after reasonable periods of time. Significant deficiencies in internal control that are not also determined to be material weaknesses, as defined in the proposed auditing standard, are not so severe as to require the auditor to conclude that internal control is ineffective. However, these deficiencies are, nonetheless, significant, and the auditor should expect the company to correct them. If, however, management fails to correct significant deficiencies within a reasonable period of time, that situation reflects poorly on tone-at-the-top, and directly on the control environment as a whole. Additionally, the significance of the deficiency can change over time (for example, major changes in sales volume or added complexity in sales transaction structures might increase the severity of a significant deficiency affecting sales).

10. Forming an Opinion and Reporting

Auditing Standard No. 2 permits the auditor to express an unqualified opinion if the auditor has identified no material weaknesses in internal control after having performed all of the procedures that the auditor considers necessary in the circumstances. In the event that the auditor cannot perform all of the procedures that the auditor considers necessary in the circumstances, Auditing Standard No. 2 permits the auditor to either qualify or disclaim an opinion. If an overall opinion cannot be expressed, Auditing Standard No. 2 requires the auditor to explain why.[4/]

[4/] See also SEC Regulation S-X 2-02(f), 17 C.F.R. § 212.2-02(f) ("The attestation report on management's assessment of internal control over financial reporting shall be dated, signed manually, identify the period covered by the report and clearly state the opinion of the accountant as to whether management's assessment of the effectiveness of the registrant's internal control over financial reporting is fairly stated in all material respects, or must include an opinion to the effect that an overall opinion cannot be expressed. If an overall opinion cannot be expressed, explain why.").

In addition, the auditor's report is to include two opinions as a result of the audit of internal control over financial reporting: one on management's assessment and one on the effectiveness of internal control over financial reporting. The Board decided that two opinions will most clearly communicate to report readers the nature and results of the work performed and most closely track with the requirements of Sections 404 and 103 of the Act.

11. No Disclosure of Significant Deficiencies

The auditor's report must follow the same disclosure model as management's assessment. The SEC's final rules implementing Section 404(a) require management's assessment to disclose only material weaknesses, not significant deficiencies. Therefore, because management's assessment will disclose only material weaknesses, the auditor's report may disclose only material weaknesses.[5/]

12. Material Weaknesses Result in Adverse Opinion on Internal Control

The previously existing attestation standard provided that when the auditor identified a material weakness in internal control, depending on the significance of the material weakness and its effect on the achievement of the objectives of the control criteria, the auditor might qualify his or her opinion ("except for the effect of the material weakness, internal control was effective") or might express an adverse opinion ("internal control over financial reporting was not effective").

The SEC's final rules implementing Section 404(a) state that "Management is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting." In other words, in such a case, management must conclude

[5/] It should be noted, however, that the final rules indicated that an aggregation of significant deficiencies may constitute a material weakness in a company's internal control over financial reporting, in which case disclosure would be required. See Final Rule: Management's Reports in Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities and Exchange Commission Release No. 33-8238, (June 5, 2003) [68 FR 36636].

that internal control is not effective (i.e., a qualified or "except for" conclusion is not allowed).

Similar to the reporting of significant deficiencies, the reporting model for the auditor must follow the required reporting model for management. Therefore, because management is required to express an "adverse" conclusion in the event a material weakness exists, the auditor's opinion on the effectiveness of internal control over financial reporting must also be adverse; Auditing Standard No. 2 does not permit a qualified opinion in the event of a material weakness. However, Auditing Standard No. 2 also requires an opinion on management's assessment in every audit report.

In the event of a material weakness, the auditor could express an unqualified opinion on management's assessment, so long as management properly identified the material weakness and concluded in their assessment that internal control was not effective.

If the auditor and management disagree about whether a material weakness exists (i.e., the auditor concludes a material weakness exists but management does not and therefore makes the conclusion in its assessment that internal control is effective), then the auditor would render an adverse opinion on management's assessment.

The Board chose for the auditor's report to express two opinions in part because it would be more informative when a material weakness exists.

13. Testing Controls Intended to Prevent or Detect Fraud

Strong internal controls provide better opportunities to detect and deter fraud. For example, many frauds resulting in financial statement restatement relied upon the ability of management to exploit weaknesses in internal control. To the extent that the internal control reporting required by Section 404 can help restore investor confidence by improving the effectiveness of internal controls (and reducing the incidence of fraud), the auditing standard on performing the audit of internal control over financial reporting should emphasize controls that prevent or detect errors as well as fraud. For this reason, Auditing Standard No. 2 specifically addresses and emphasizes the importance of controls over possible fraud and requires the auditor to test controls specifically intended to prevent or detect fraud that is reasonably possible to result in material misstatement of the financial statements.

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* * *

On the 9th day of March, in the year 2004, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour
Acting Secretary

March 9, 2004

APPENDIX – Auditing Standard No. 2 – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

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Appendix – Auditing Standard No. 2

March 9, 2004
AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Auditing Standard No. 2 –

An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements

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Applicability of Standard

1. This standard establishes requirements and provides directions that apply when an auditor is engaged to audit both a company's financial statements and management's assessment of the effectiveness of internal control over financial reporting.

> Note: The term *auditor* includes both public accounting firms registered with the Public Company Accounting Oversight Board ("PCAOB" or the "Board") and associated persons thereof.

2. A company subject to the reporting requirements of the Securities Exchange Act of 1934 (an "issuer") is required to include in its annual report a report of management on the company's internal control over financial reporting. Registered investment companies, issuers of asset-backed securities, and nonpublic companies are not subject to the reporting requirements mandated by Section 404 of the Sarbanes-Oxley Act of 2002 (the "Act") (PL 107-204). The report of management is required to contain management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including a statement as to whether the company's internal control over financial reporting is effective. The auditor that audits the company's financial statements included in the annual report is required to attest to and report on management's assessment. The company is required to file the auditor's attestation report as part of the annual report.

> Note: The term issuer means an issuer (as defined in Section 3 of the Securities Exchange Act of 1934), the securities of which are registered under Section 12 of that Act, or that is required to file reports under Section 15(d) of that Act, or that files or has filed a registration statement with the Securities and Exchange Commission ("SEC" or "Commission") that has not yet become effective under the Securities Act of 1933, and that it has not withdrawn.

> Note: Various parts of this standard summarize legal requirements imposed on issuers by the SEC, as well as legal requirements imposed on auditors by regulatory authorities other than the PCAOB. These parts of the standard are intended to provide context and to promote the auditor's understanding of the relationship between his or her obligations under this standard and his or her other legal responsibilities. The standard does not incorporate these legal

requirements by reference and is not an interpretation of those other requirements and should not be so construed. (This Note does not apply to references in the standard to the existing professional standards and the Board's interim auditing and related professional practice standards.)

3. This standard is the standard on attestation engagements referred to in Section 404(b) of the Act. This standard is also the standard referred to in Section 103(a)(2)(A)(iii) of the Act. Throughout this standard, the auditor's attestation of management's assessment of the effectiveness of internal control over financial reporting required by Section 404(b) of the Act is referred to as the *audit of internal control over financial reporting*.

Note: The two terms *audit of internal control over financial reporting* and *attestation of management's assessment of the effectiveness of internal control over financial reporting* refer to the same professional service. The first refers to the process, and the second refers to the result of that process.

Auditor's Objective in an Audit of Internal Control Over Financial Reporting

4. The auditor's objective in an audit of internal control over financial reporting is to express an opinion on management's assessment of the effectiveness of the company's internal control over financial reporting. To form a basis for expressing such an opinion, the auditor must plan and perform the audit to obtain reasonable assurance about whether the company maintained, in all material respects, effective internal control over financial reporting as of the date specified in management's assessment. The auditor also must audit the company's financial statements as of the date specified in management's assessment because the information the auditor obtains during a financial statement audit is relevant to the auditor's conclusion about the effectiveness of the company's internal control over financial reporting. Maintaining effective internal control over financial reporting means that no material weaknesses exist; therefore, the objective of the audit of internal control over financial reporting is to obtain reasonable assurance that no material weaknesses exist as of the date specified in management's assessment.

5. To obtain reasonable assurance, the auditor evaluates the assessment performed by management and obtains and evaluates evidence about whether the

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internal control over financial reporting was designed and operated effectively. The auditor obtains this evidence from a number of sources, including using the work performed by others and performing auditing procedures himself or herself.

6. The auditor should be aware that persons who rely on the information concerning internal control over financial reporting include investors, creditors, the board of directors and audit committee, and regulators in specialized industries, such as banking or insurance. The auditor should be aware that external users of financial statements are interested in information on internal control over financial reporting because it enhances the quality of financial reporting and increases their confidence in financial information, including financial information issued between annual reports, such as quarterly information. Information on internal control over financial reporting is also intended to provide an early warning to those inside and outside the company who are in a position to insist on improvements in internal control over financial reporting, such as the audit committee and regulators in specialized industries. Additionally, Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a),[1/] whichever applies, require management, with the participation of the principal executive and financial officers, to make quarterly and annual certifications with respect to the company's internal control over financial reporting.

Definitions Related to Internal Control Over Financial Reporting

7. For purposes of management's assessment and the audit of internal control over financial reporting in this standard, *internal control over financial reporting* is defined as follows:

> A process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

[1/] See 17 C.F.R. 240.13a-14(a) or 17 C.F.R. 240.15d-14(a), whichever applies.

(1) Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;

(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Note: This definition is the same one used by the SEC in its rules requiring management to report on internal control over financial reporting, except the word "registrant" has been changed to "company" to conform to the wording in this standard. (See Securities Exchange Act Rules 13a-15(f) and 15d-15(f).[2/])

Note: Throughout this standard, *internal control over financial reporting* (singular) refers to the process described in this paragraph. Individual controls or subsets of controls are referred to as *controls* or *controls over financial reporting*.

8. A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

- A deficiency in *design* exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective is not always met.

- A deficiency in *operation* exists when a properly designed control does not operate as designed, or when the person performing the control does not

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2/ See 17 C.F.R. 240, 13a-15(f) and 15d-15(f).

possess the necessary authority or qualifications to perform the control effectively.

9. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected.

Note: The term "remote likelihood" as used in the definitions of *significant deficiency* and *material weakness* (paragraph 10) has the same meaning as the term "remote" as used in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies* ("FAS No. 5"). Paragraph 3 of FAS No. 5 states:

> When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms *probable*, *reasonably possible*, and *remote* to identify three areas within that range, as follows:
>
> a. *Probable*. The future event or events are likely to occur.
> b. *Reasonably possible*. The chance of the future event or events occurring is more than remote but less than likely.
> c. *Remote*. The chance of the future events or events occurring is slight.

Therefore, the likelihood of an event is "more than remote" when it is either reasonably possible or probable.

Note: A misstatement is *inconsequential* if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, either individually or when aggregated with other misstatements, would clearly be immaterial to the financial statements. If a reasonable person could not reach such a conclusion regarding a particular misstatement, that misstatement is *more than inconsequential*.

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10. A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

Note: In evaluating whether a control deficiency exists and whether control deficiencies, either individually or in combination with other control deficiencies, are significant deficiencies or material weaknesses, the auditor should consider the definitions in paragraphs 8, 9 and 10, and the directions in paragraphs 130 through 137. As explained in paragraph 23, the evaluation of the materiality of the control deficiency should include both quantitative and qualitative considerations. Qualitative factors that might be important in this evaluation include the nature of the financial statement accounts and assertions involved and the reasonably possible future consequences of the deficiency. Furthermore, in determining whether a control deficiency or combination of deficiencies is a significant deficiency or a material weakness, the auditor should evaluate the effect of compensating controls and whether such compensating controls are effective.

11. Controls over financial reporting may be *preventive controls* or *detective controls*.

- Preventive controls have the objective of preventing errors or fraud from occurring in the first place that could result in a misstatement of the financial statements.

- Detective controls have the objective of detecting errors or fraud that have already occurred that could result in a misstatement of the financial statements.

12. Even well-designed controls that are operating as designed might not prevent a misstatement from occurring. However, this possibility may be countered by overlapping preventive controls or partially countered by detective controls. Therefore, effective internal control over financial reporting often includes a combination of preventive and detective controls to achieve a specific control objective. The auditor's procedures as part of either the audit of internal control over financial reporting or the audit of the financial statements are not part of a company's internal control over financial reporting.

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Framework Used by Management to Conduct Its Assessment

13. Management is required to base its assessment of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework established by a body of experts that followed due-process procedures, including the broad distribution of the framework for public comment. In addition to being available to users of management's reports, a framework is suitable only when it:

- Is free from bias;
- Permits reasonably consistent qualitative and quantitative measurements of a company's internal control over financial reporting;
- Is sufficiently complete so that those relevant factors that would alter a conclusion about the effectiveness of a company's internal control over financial reporting are not omitted; and
- Is relevant to an evaluation of internal control over financial reporting.

Committee of Sponsoring Organizations Framework

14. In the United States, the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission has published *Internal Control – Integrated Framework*. Known as the COSO report, it provides a suitable and available framework for purposes of management's assessment. For that reason, the performance and reporting directions in this standard are based on the COSO framework. Other suitable frameworks have been published in other countries and may be developed in the future. Such other suitable frameworks may be used in an audit of internal control over financial reporting. Although different frameworks may not contain exactly the same elements as COSO, they should have elements that encompass, in general, all the themes in COSO. Therefore, the auditor should be able to apply the concepts and guidance in this standard in a reasonable manner.

15. The COSO framework identifies three primary objectives of internal control: efficiency and effectiveness of operations, financial reporting, and compliance with laws and regulations. The COSO perspective on internal control over financial reporting does not ordinarily include the other two objectives of internal control, which are the

effectiveness and efficiency of operations and compliance with laws and regulations. However, the controls that management designs and implements may achieve more than one objective. Also, operations and 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. Additionally, not all controls relevant to financial reporting are accounting controls. Accordingly, all controls that could materially affect financial reporting, including controls that focus primarily on the effectiveness and efficiency of operations or compliance with laws and regulations and also have a material effect on the reliability of financial reporting, are a part of internal control over financial reporting. More information about the COSO framework is included in the COSO report and in AU sec. 319, Consideration of Internal Control in a Financial Statement Audit.[3/] The COSO report also discusses special considerations for internal control over financial reporting for small and medium-sized companies.

Inherent Limitations in Internal Control Over Financial Reporting

16. Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

[3/] The Board adopted the generally accepted auditing standards, as described in the AICPA Auditing Standards Board's ("ASB") Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards,* as in existence on April 16, 2003, on an initial, transitional basis. The Statements on Auditing Standards promulgated by the ASB have been codified into the AICPA *Professional Standards*, Volume 1, as AU sections 100 through 900. References in this standard to AU sections refer to those generally accepted auditing standards, as adopted on an interim basis in PCAOB Rule 3200T.

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The Concept of Reasonable Assurance

17. Management's assessment of the effectiveness of internal control over financial reporting is expressed at the level of *reasonable assurance*. The concept of reasonable assurance is built into the definition of internal control over financial reporting and also is integral to the auditor's opinion.[4/] Reasonable assurance includes the understanding that there is a remote likelihood that material misstatements will not be prevented or detected on a timely basis. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance.

18. Just as there are inherent limitations on the assurance that effective internal control over financial reporting can provide, as discussed in paragraph 16, there are limitations on the amount of assurance the auditor can obtain as a result of performing his or her audit of internal control over financial reporting. Limitations arise because an audit is conducted on a test basis and requires the exercise of professional judgment. Nevertheless, the audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control over financial reporting, and performing such other procedures as the auditor considers necessary to obtain reasonable assurance about whether internal control over financial reporting is effective.

19. There is no difference in the level of work performed or assurance obtained by the auditor when expressing an opinion on management's assessment of effectiveness or when expressing an opinion directly on the effectiveness of internal control over financial reporting. In either case, the auditor must obtain sufficient evidence to provide a reasonable basis for his or her opinion and the use and evaluation of management's assessment is inherent in expressing either opinion.

> Note: The auditor's report on internal control over financial reporting does not relieve management of its responsibility for assuring users of its financial reports about the effectiveness of internal control over financial reporting.

[4/] See *Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, Securities and Exchange Commission Release No. 33-8238 (June 5, 2003) [68 FR 36636] for further discussion of reasonable assurance.

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Management's Responsibilities in an Audit of Internal Control Over Financial Reporting

20. For the auditor to satisfactorily complete an audit of internal control over financial reporting, management must do the following:[5/]

a. Accept responsibility for the effectiveness of the company's internal control over financial reporting;

b. Evaluate the effectiveness of the company's internal control over financial reporting using suitable control criteria;

c. Support its evaluation with sufficient evidence, including documentation; and

d. Present a written assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year.

21. If the auditor concludes that management has not fulfilled the responsibilities enumerated in the preceding paragraph, the auditor should communicate, in writing, to management and the audit committee that the audit of internal control over financial reporting cannot be satisfactorily completed and that he or she is required to disclaim an opinion. Paragraphs 40 through 46 provide information for the auditor about evaluating management's process for assessing internal control over financial reporting.

Materiality Considerations in an Audit of Internal Control Over Financial Reporting

22. The auditor should apply the concept of materiality in an audit of internal control over financial reporting at both the financial-statement level and at the individual account-balance level. The auditor uses materiality at the financial-statement level in evaluating whether a deficiency, or combination of deficiencies, in controls is a

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[5/] Management is required to fulfill these responsibilities. See Items 308(a) and (c) of Regulation S-B and S-K, 17 C.F.R. 228.308 (a) and (c) and 229.308 (a) and (c), respectively.

significant deficiency or a material weakness. Materiality at both the financial-statement level and the individual account-balance level is relevant to planning the audit and designing procedures. Materiality at the account-balance level is necessarily lower than materiality at the financial-statement level.

23. The same conceptual definition of materiality that applies to financial reporting applies to information on internal control over financial reporting, including the relevance of both quantitative and qualitative considerations.[6/]

- The quantitative considerations are essentially the same as in an audit of financial statements and relate to whether misstatements that would not be prevented or detected by internal control over financial reporting, individually or collectively, have a quantitatively material effect on the financial statements.

- The qualitative considerations apply to evaluating materiality with respect to the financial statements and to additional factors that relate to the perceived needs of reasonable persons who will rely on the information. Paragraph 6 describes some qualitative considerations.

Fraud Considerations in an Audit of Internal Control Over Financial Reporting

24. The auditor should evaluate all controls specifically intended to address the risks of fraud that have at least a reasonably possible likelihood of having a material effect on the company's financial statements. These controls may be a part of any of the five components of internal control over financial reporting, as discussed in paragraph 49. Controls related to the prevention and detection of fraud often have a pervasive effect on the risk of fraud. Such controls include, but are not limited to, the:

- Controls restraining misappropriation of company assets that could result in a material misstatement of the financial statements;

- Company's risk assessment processes;

[6/] AU sec. 312, *Audit Risk and Materiality in Conducting an Audit,* provides additional explanation of materiality.

- Code of ethics/conduct provisions, especially those related to conflicts of interest, related party transactions, illegal acts, and the monitoring of the code by management and the audit committee or board;

- Adequacy of the internal audit activity and whether the internal audit function reports directly to the audit committee, as well as the extent of the audit committee's involvement and interaction with internal audit; and

- Adequacy of the company's procedures for handling complaints and for accepting confidential submissions of concerns about questionable accounting or auditing matters.

25. Part of management's responsibility when designing a company's internal control over financial reporting is to design and implement programs and controls to prevent, deter, and detect fraud. Management, along with those who have responsibility for oversight of the financial reporting process (such as the audit committee), should set the proper tone; create and maintain a culture of honesty and high ethical standards; and establish appropriate controls to prevent, deter, and detect fraud. When management and those responsible for the oversight of the financial reporting process fulfill those responsibilities, the opportunities to commit fraud can be reduced significantly.

26. In an audit of internal control over financial reporting, the auditor's evaluation of controls is interrelated with the auditor's evaluation of controls in a financial statement audit, as required by AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*. Often, controls identified and evaluated by the auditor during the audit of internal control over financial reporting also address or mitigate fraud risks, which the auditor is required to consider in a financial statement audit. If the auditor identifies deficiencies in controls designed to prevent and detect fraud during the audit of internal control over financial reporting, the auditor should alter the nature, timing, or extent of procedures to be performed during the financial statement audit to be responsive to such deficiencies, as provided in paragraphs .44 and .45 of AU sec. 316.

Performing an Audit of Internal Control Over Financial Reporting

27. In an audit of internal control over financial reporting, the auditor must obtain sufficient competent evidence about the design and operating effectiveness of controls

over all relevant financial statement assertions related to all significant accounts and disclosures in the financial statements. The auditor must plan and perform the audit to obtain reasonable assurance that deficiencies that, individually or in the aggregate, would represent material weaknesses are identified. Thus, the audit is not designed to detect deficiencies in internal control over financial reporting that, individually or in the aggregate, are less severe than a material weakness. Because of the potential significance of the information obtained during the audit of the financial statements to the auditor's conclusions about the effectiveness of internal control over financial reporting, the auditor cannot audit internal control over financial reporting without also auditing the financial statements.

> Note: However, the auditor may audit the financial statements without also auditing internal control over financial reporting, for example, in the case of certain initial public offerings by a company. See the discussion beginning at paragraph 145 for more information about the importance of auditing both internal control over financial reporting as well as the financial statements when the auditor is engaged to audit internal control over financial reporting.

28. The auditor must adhere to the general standards (See paragraphs 30 through 36) and fieldwork and reporting standards (See paragraph 37) in performing an audit of a company's internal control over financial reporting. This involves the following:

a. Planning the engagement;

b. Evaluating management's assessment process;

c. Obtaining an understanding of internal control over financial reporting;

d. Testing and evaluating design effectiveness of internal control over financial reporting;

e. Testing and evaluating operating effectiveness of internal control over financial reporting; and

f. Forming an opinion on the effectiveness of internal control over financial reporting.

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29. Even though some requirements of this standard are set forth in a manner that suggests a sequential process, auditing internal control over financial reporting involves a process of gathering, updating, and analyzing information. Accordingly, the auditor may perform some of the procedures and evaluations described in this section on "Performing an Audit of Internal Control Over Financial Reporting" concurrently.

Applying General, Fieldwork, and Reporting Standards

30. The general standards (See AU sec. 150, *Generally Accepted Auditing Standards*) are applicable to an audit of internal control over financial reporting. These standards require technical training and proficiency as an auditor, independence in fact and appearance, and the exercise of due professional care, including professional skepticism.

31. *Technical Training and Proficiency*. To perform an audit of internal control over financial reporting, the auditor should have competence in the subject matter of internal control over financial reporting.

32. *Independence*. The applicable requirements of independence are largely predicated on four basic principles: (1) an auditor must not act as management or as an employee of the audit client, (2) an auditor must not audit his or her own work, (3) an auditor must not serve in a position of being an advocate for his or her client, and (4) an auditor must not have mutual or conflicting interests with his or her audit client.[7/] If the auditor were to design or implement controls, that situation would place the auditor in a management role and result in the auditor auditing his or her own work. These requirements, however, do not preclude the auditor from making substantive recommendations as to how management may improve the design or operation of the company's internal controls as a by-product of an audit.

33. The auditor must not accept an engagement to provide internal control-related services to an issuer for which the auditor also audits the financial statements unless that engagement has been specifically pre-approved by the audit committee. For any internal control services the auditor provides, management must be actively involved and cannot delegate responsibility for these matters to the auditor. Management's

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[7/] See the Preliminary Note of Rule 2-01 of Regulation S-X, 17 C.F.R. 210.2-01.

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involvement must be substantive and extensive. Management's acceptance of responsibility for documentation and testing performed by the auditor does not by itself satisfy the independence requirements.

34. Maintaining independence, in fact and appearance, requires careful attention, as is the case with all independence issues when work concerning internal control over financial reporting is performed. Unless the auditor and the audit committee are diligent in evaluating the nature and extent of services provided, the services might violate basic principles of independence and cause an impairment of independence in fact or appearance.

35. The independent auditor and the audit committee have significant and distinct responsibilities for evaluating whether the auditor's services impair independence in fact or appearance. The test for independence in fact is whether the activities would impede the ability of anyone on the engagement team or in a position to influence the engagement team from exercising objective judgment in the audits of the financial statements or internal control over financial reporting. The test for independence in appearance is whether a reasonable investor, knowing all relevant facts and circumstances, would perceive an auditor as having interests which could jeopardize the exercise of objective and impartial judgments on all issues encompassed within the auditor's engagement.

36. *Due Professional Care*. The auditor must exercise due professional care in an audit of internal control over financial reporting. One important tenet of due professional care is exercising professional skepticism. In an audit of internal control over financial reporting, exercising professional skepticism involves essentially the same considerations as in an audit of financial statements, that is, it includes a critical assessment of the work that management has performed in evaluating and testing controls.

37. *Fieldwork and Reporting Standards*. This standard establishes the fieldwork and reporting standards applicable to an audit of internal control over financial reporting.

38. The concept of materiality, as discussed in paragraphs 22 and 23, underlies the application of the general and fieldwork standards.

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Planning the Engagement

39. The audit of internal control over financial reporting should be properly planned and assistants, if any, are to be properly supervised. When planning the audit of internal control over financial reporting, the auditor should evaluate how the following matters will affect the auditor's procedures:

- Knowledge of the company's internal control over financial reporting obtained during other engagements.
- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes.
- Matters relating to the company's business, including its organization, operating characteristics, capital structure, and distribution methods.
- The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting.
- Management's process for assessing the effectiveness of the company's internal control over financial reporting based upon control criteria.
- Preliminary judgments about materiality, risk, and other factors relating to the determination of material weaknesses.
- Control deficiencies previously communicated to the audit committee or management.
- Legal or regulatory matters of which the company is aware.
- The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting.
- Preliminary judgments about the effectiveness of internal control over financial reporting.

- The number of significant business locations or units, including management's documentation and monitoring of controls over such locations or business units. (Appendix B, paragraphs B1 through B17, discusses factors the auditor should evaluate to determine the locations at which to perform auditing procedures.)

Evaluating Management's Assessment Process

40. The auditor must obtain an understanding of, and evaluate, management's process for assessing the effectiveness of the company's internal control over financial reporting. When obtaining the understanding, the auditor should determine whether management has addressed the following elements:

- Determining which controls should be tested, including controls over all relevant assertions related to all significant accounts and disclosures in the financial statements. Generally, such controls include:

  – Controls over initiating, authorizing, recording, processing, and reporting significant accounts and disclosures and related assertions embodied in the financial statements.

  – Controls over the selection and application of accounting policies that are in conformity with generally accepted accounting principles.

  – Antifraud programs and controls.

  – Controls, including information technology general controls, on which other controls are dependent.

  – Controls over significant nonroutine and nonsystematic transactions, such as accounts involving judgments and estimates.

  – Company level controls (as described in paragraph 53), including:

    – The control environment and

– Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; to initiate, authorize, record, and process journal entries in the general ledger; and to record recurring and nonrecurring adjustments to the financial statements (for example, consolidating adjustments, report combinations, and reclassifications).

Note: References to the period-end financial reporting process in this standard refer to the preparation of both annual and quarterly financial statements.

- Evaluating the likelihood that failure of the control could result in a misstatement, the magnitude of such a misstatement, and the degree to which other controls, if effective, achieve the same control objectives.

- Determining the locations or business units to include in the evaluation for a company with multiple locations or business units (See paragraphs B1 through B17).

- Evaluating the design effectiveness of controls.

- Evaluating the operating effectiveness of controls based on procedures sufficient to assess their operating effectiveness. Examples of such procedures include testing of the controls by internal audit, testing of controls by others under the direction of management, using a service organization's reports (See paragraphs B18 through B29), inspection of evidence of the application of controls, or testing by means of a self-assessment process, some of which might occur as part of management's ongoing monitoring activities. Inquiry alone is not adequate to complete this evaluation. To evaluate the effectiveness of the company's internal control over financial reporting, management must have evaluated controls over all relevant assertions related to all significant accounts and disclosures.

- Determining the deficiencies in internal control over financial reporting that are of such a magnitude and likelihood of occurrence that they constitute significant deficiencies or material weaknesses.

- Communicating findings to the auditor and to others, if applicable.

- Evaluating whether findings are reasonable and support management's assessment.

41. As part of the understanding and evaluation of management's process, the auditor should obtain an understanding of the results of procedures performed by others. Others include internal audit and third parties working under the direction of management, including other auditors and accounting professionals engaged to perform procedures as a basis for management's assessment. Inquiry of management and others is the beginning point for obtaining an understanding of internal control over financial reporting, but inquiry alone is not adequate for reaching a conclusion on any aspect of internal control over financial reporting effectiveness.

Note: Management cannot use the auditor's procedures as part of the basis for its assessment of the effectiveness of internal control over financial reporting.

42. *Management's Documentation*. When determining whether management's documentation provides reasonable support for its assessment, the auditor should evaluate whether such documentation includes the following:

- The design of controls over all relevant assertions related to all significant accounts and disclosures in the financial statements. The documentation should include the five components of internal control over financial reporting as discussed in paragraph 49, including the control environment and company-level controls as described in paragraph 53;

- Information about how significant transactions are initiated, authorized, recorded, processed and reported;

- Sufficient information about the flow of transactions to identify the points at which material misstatements due to error or fraud could occur;

- Controls designed to prevent or detect fraud, including who performs the controls and the related segregation of duties;

- Controls over the period-end financial reporting process;

- Controls over safeguarding of assets (See paragraphs C1 through C6); and

- The results of management's testing and evaluation.

43. Documentation might take many forms, such as paper, electronic files, or other media, and can include a variety of information, including policy manuals, process models, flowcharts, job descriptions, documents, and forms. The form and extent of documentation will vary depending on the size, nature, and complexity of the company.

44. Documentation of the design of controls over relevant assertions related to significant accounts and disclosures is evidence that controls related to management's assessment of the effectiveness of internal control over financial reporting, including changes to those controls, have been identified, are capable of being communicated to those responsible for their performance, and are capable of being monitored by the company. Such documentation also provides the foundation for appropriate communication concerning responsibilities for performing controls and for the company's evaluation of and monitoring of the effective operation of controls.

45. Inadequate documentation of the design of controls over relevant assertions related to significant accounts and disclosures is a deficiency in the company's internal control over financial reporting. As discussed in paragraph 138, the auditor should evaluate this documentation deficiency. The auditor might conclude that the deficiency is only a deficiency, or that the deficiency represents a significant deficiency or a material weakness. In evaluating the deficiency as to its significance, the auditor should determine whether management can demonstrate the monitoring component of internal control over financial reporting.

46. Inadequate documentation also could cause the auditor to conclude that there is a limitation on the scope of the engagement.

Obtaining an Understanding of Internal Control Over Financial Reporting

47. The auditor should obtain an understanding of the design of specific controls by applying procedures that include:

- Making inquiries of appropriate management, supervisory, and staff personnel;
- Inspecting company documents;
- Observing the application of specific controls; and
- Tracing transactions through the information system relevant to financial reporting.

48. The auditor could also apply additional procedures to obtain an understanding of the design of specific controls.

49. The auditor must obtain an understanding of the design of controls related to each component of internal control over financial reporting, as discussed below.

- *Control Environment*. Because of the pervasive effect of the control environment on the reliability of financial reporting, the auditor's preliminary judgment about its effectiveness often influences the nature, timing, and extent of the tests of operating effectiveness considered necessary. Weaknesses in the control environment should cause the auditor to alter the nature, timing, or extent of tests of operating effectiveness that otherwise should have been performed in the absence of the weaknesses.
- *Risk Assessment*. When obtaining an understanding of the company's risk assessment process, the auditor should evaluate whether management has identified the risks of material misstatement in the significant accounts and disclosures and related assertions of the financial statements and has implemented controls to prevent or detect errors or fraud that could result in material misstatements. For example, the risk assessment process should address how management considers the

possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements. Risks relevant to reliable financial reporting also relate to specific events or transactions.

- *Control Activities*. The auditor's understanding of control activities relates to the controls that management has implemented to prevent or detect errors or fraud that could result in material misstatement in the accounts and disclosures and related assertions of the financial statements. For the purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained for the financial statement audit.

- *Information and Communication*. The auditor's understanding of management's information and communication involves understanding the same systems and processes that he or she addresses in an audit of financial statements. In addition, this understanding includes a greater emphasis on comprehending the safeguarding controls and the processes for authorization of transactions and the maintenance of records, as well as the period-end financial reporting process (discussed further beginning at paragraph 76).

- *Monitoring*. The auditor's understanding of management's monitoring of controls extends to and includes its monitoring of all controls, including control activities, which management has identified and designed to prevent or detect material misstatement in the accounts and disclosures and related assertions of the financial statements.

50. Some controls (such as company-level controls, described in paragraph 53) might have a pervasive effect on the achievement of many overall objectives of the control criteria. For example, information technology general controls over program development, program changes, computer operations, and access to programs and data help ensure that specific controls over the processing of transactions are operating effectively. In contrast, other controls are designed to achieve specific objectives of the control criteria. For example, management generally establishes specific controls, such as accounting for all shipping documents, to ensure that all valid sales are recorded.

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51. The auditor should focus on combinations of controls, in addition to specific controls in isolation, in assessing whether the objectives of the control criteria have been achieved. The absence or inadequacy of a specific control designed to achieve the objectives of a specific criterion might not be a deficiency if other controls specifically address the same criterion. Further, when one or more controls achieve the objectives of a specific criterion, the auditor might not need to evaluate other controls designed to achieve those same objectives.

52. *Identifying Company-Level Controls*. Controls that exist at the company-level often have a pervasive impact on controls at the process, transaction, or application level. For that reason, as a practical consideration, it may be appropriate for the auditor to test and evaluate the design effectiveness of company-level controls first, because the results of that work might affect the way the auditor evaluates the other aspects of internal control over financial reporting.

53. Company-level controls are controls such as the following:

- Controls within the control environment, including tone at the top, the assignment of authority and responsibility, consistent policies and procedures, and company-wide programs, such as codes of conduct and fraud prevention, that apply to all locations and business units (See paragraphs 113 through 115 for further discussion);

- Management's risk assessment process;

- Centralized processing and controls, including shared service environments;

- Controls to monitor results of operations;

- Controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs;

- The period-end financial reporting process; and

- Board-approved policies that address significant business control and risk management practices.

Note: The controls listed above are not intended to be a complete list of company-level controls nor is a company required to have all the controls in the list to support its assessment of effective company-level controls. However, ineffective company-level controls are a deficiency that will affect the scope of work performed, particularly when a company has multiple locations or business units, as described in Appendix B.

54. Testing company-level controls alone is not sufficient for the purpose of expressing an opinion on the effectiveness of a company's internal control over financial reporting.

55. *Evaluating the Effectiveness of the Audit Committee's Oversight of the Company's External Financial Reporting and Internal Control Over Financial Reporting*. The company's audit committee plays an important role within the control environment and monitoring components of internal control over financial reporting. Within the control environment, the existence of an effective audit committee helps to set a positive tone at the top. Within the monitoring component, an effective audit committee challenges the company's activities in the financial arena.

Note: Although the audit committee plays an important role within the control environment and monitoring components of internal control over financial reporting, management is responsible for maintaining effective internal control over financial reporting. This standard does not suggest that this responsibility has been transferred to the audit committee.

Note: If no such committee exists with respect to the company, all references to the audit committee in this standard apply to the entire board of directors of the company.[8/] The auditor should be aware that companies whose securities are not listed on a national securities exchange or an automated inter-dealer quotation system of a national securities association (such as the New York Stock Exchange, American Stock Exchange, or NASDAQ) may not be required to have independent directors for their audit committees. In this case, the auditor should not consider the lack of independent directors at these companies

[8/] See 15 U.S.C. 78c(a)58 and 15 U.S.C. 7201(a)(3).

indicative, by itself, of a control deficiency. Likewise, the independence requirements of Securities Exchange Act Rule 10A-3[9/] are not applicable to the listing of non-equity securities of a consolidated or at least 50 percent beneficially owned subsidiary of a listed issuer that is subject to the requirements of Securities Exchange Act Rule 10A-3(c)(2).[10/] Therefore, the auditor should interpret references to the audit committee in this standard, as applied to a subsidiary registrant, as being consistent with the provisions of Securities Exchange Act Rule 10A-3(c)(2).[11/] Furthermore, for subsidiary registrants, communications required by this standard to be directed to the audit committee should be made to the same committee or equivalent body that pre-approves the retention of the auditor by or on behalf of the subsidiary registrant pursuant to Rule 2-01(c)(7) of Regulation S-X[12/] (which might be, for example, the audit committee of the subsidiary registrant, the full board of the subsidiary registrant, or the audit committee of the subsidiary registrant's parent). In all cases, the auditor should interpret the terms "board of directors" and "audit committee" in this standard as being consistent with provisions for the use of those terms as defined in relevant SEC rules.

56. The company's board of directors is responsible for evaluating the performance and effectiveness of the audit committee; this standard does not suggest that the auditor is responsible for performing a separate and distinct evaluation of the audit committee. However, because of the role of the audit committee within the control environment and monitoring components of internal control over financial reporting, the auditor should assess the effectiveness of the audit committee as part of understanding and evaluating those components.

57. The aspects of the audit committee's effectiveness that are important may vary considerably with the circumstances. The auditor focuses on factors related to the effectiveness of the audit committee's oversight of the company's external financial

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9/ See 17 C.F.R. 240.10A-3.

10/ See 17 C.F.R. 240.10A-3(c)(2).

11/ See 17 C.F.R. 240.10A-3(c)(2).

12/ See 17 C.F.R. 210.2-01(c)(7).

reporting and internal control over financial reporting, such as the independence of the audit committee members from management and the clarity with which the audit committee's responsibilities are articulated (for example, in the audit committee's charter) and how well the audit committee and management understand those responsibilities. The auditor might also consider the audit committee's involvement and interaction with the independent auditor and with internal auditors, as well as interaction with key members of financial management, including the chief financial officer and chief accounting officer.

58. The auditor might also evaluate whether the right questions are raised and pursued with management and the auditor, including questions that indicate an understanding of the critical accounting policies and judgmental accounting estimates, and the responsiveness to issues raised by the auditor.

59. Ineffective oversight by the audit committee of the company's external financial reporting and internal control over financial reporting should be regarded as at least a significant deficiency and is a strong indicator that a material weakness in internal control over financial reporting exists.

60. *Identifying Significant Accounts*. The auditor should identify significant accounts and disclosures, first at the financial-statement level and then at the account or disclosure-component level. Determining specific controls to test begins by identifying significant accounts and disclosures within the financial statements. When identifying significant accounts, the auditor should evaluate both quantitative and qualitative factors.

61. An account is significant if there is more than a remote likelihood that the account could contain misstatements that individually, or when aggregated with others, could have a material effect on the financial statements, considering the risks of both overstatement and understatement. Other accounts may be significant on a qualitative basis based on the expectations of a reasonable user. For example, investors might be interested in a particular financial statement account even though it is not quantitatively large because it represents an important performance measure.

> Note: For purposes of determining significant accounts, the assessment as to likelihood should be made without giving any consideration to the effectiveness of internal control over financial reporting.

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62. Components of an account balance subject to differing risks (inherent and control) or different controls should be considered separately as potential significant accounts. For instance, inventory accounts often consist of raw materials (purchasing process), work in process (manufacturing process), finished goods (distribution process), and an allowance for obsolescence.

63. In some cases, separate components of an account might be a significant account because of the company's organizational structure. For example, for a company that has a number of separate business units, each with different management and accounting processes, the accounts at each separate business unit are considered individually as potential significant accounts.

64. An account also may be considered significant because of the exposure to unrecognized obligations represented by the account. For example, loss reserves related to a self-insurance program or unrecorded contractual obligations at a construction contracting subsidiary may have historically been insignificant in amount, yet might represent a more than remote likelihood of material misstatement due to the existence of material unrecorded claims.

65. When deciding whether an account is significant, it is important for the auditor to evaluate both quantitative and qualitative factors, including the:

- Size and composition of the account;
- Susceptibility of loss due to errors or fraud;
- Volume of activity, complexity, and homogeneity of the individual transactions processed through the account;
- Nature of the account (for example, suspense accounts generally warrant greater attention);
- Accounting and reporting complexities associated with the account;
- Exposure to losses represented by the account (for example, loss accruals related to a consolidated construction contracting subsidiary);

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- Likelihood (or possibility) of significant contingent liabilities arising from the activities represented by the account;

- Existence of related party transactions in the account; and

- Changes from the prior period in account characteristics (for example, new complexities or subjectivity or new types of transactions).

66. For example, in a financial statement audit, the auditor might not consider the fixed asset accounts significant when there is a low volume of transactions and when inherent risk is assessed as low, even though the balances are material to the financial statements. Accordingly, he or she might decide to perform only substantive procedures on such balances. In an audit of internal control over financial reporting, however, such accounts are significant accounts because of their materiality to the financial statements.

67. As another example, the auditor of the financial statements of a financial institution might not consider trust accounts significant to the institution's financial statements because such accounts are not included in the institution's balance sheet and the associated fee income generated by trust activities is not material. However, in determining whether trust accounts are a significant account for purposes of the audit of internal control over financial reporting, the auditor should assess whether the activities of the trust department are significant to the institution's financial reporting, which also would include considering the contingent liabilities that could arise if a trust department failed to fulfill its fiduciary responsibilities (for example, if investments were made that were not in accordance with stated investment policies). When assessing the significance of possible contingent liabilities, consideration of the amount of assets under the trust department's control may be useful. For this reason, an auditor who has not considered trust accounts significant accounts for purposes of the financial statement audit might determine that they are significant for purposes of the audit of internal control over financial reporting.

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68. Identifying Relevant Financial Statement Assertions. For each significant account, the auditor should determine the relevance of each of these financial statement assertions:[13/]

- Existence or occurrence;
- Completeness;
- Valuation or allocation;
- Rights and obligations; and
- Presentation and disclosure.

69. To identify relevant assertions, the auditor should determine the source of likely potential misstatements in each significant account. In determining whether a particular assertion is relevant to a significant account balance or disclosure, the auditor should evaluate:

- The nature of the assertion;
- The volume of transactions or data related to the assertion; and
- The nature and complexity of the systems, including the use of information technology by which the company processes and controls information supporting the assertion.

70. *Relevant assertions* are assertions that have a meaningful bearing on whether the account is fairly stated. For example, valuation may not be relevant to the cash account unless currency translation is involved; however, existence and completeness are always relevant. Similarly, valuation may not be relevant to the gross amount of the accounts receivable balance, but is relevant to the related allowance accounts. Additionally, the auditor might, in some circumstances, focus on the presentation and

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[13/] See AU sec. 326, *Evidential Matter*, which provides additional information on financial statement assertions.

disclosure assertion separately in connection with the period-end financial reporting process.

71. *Identifying Significant Processes and Major Classes of Transactions*. The auditor should identify each significant process over each major class of transactions affecting significant accounts or groups of accounts. Major classes of transactions are those classes of transactions that are significant to the company's financial statements. For example, at a company whose sales may be initiated by customers through personal contact in a retail store or electronically through use of the internet, these types of sales would be two major classes of transactions within the sales process if they were both significant to the company's financial statements. As another example, at a company for which fixed assets is a significant account, recording depreciation expense would be a major class of transactions.

72. Different types of major classes of transactions have different levels of inherent risk associated with them and require different levels of management supervision and involvement. For this reason, the auditor might further categorize the identified major classes of transactions by transaction type: routine, nonroutine, and estimation.

- Routine transactions are recurring financial activities reflected in the accounting records in the normal course of business (for example, sales, purchases, cash receipts, cash disbursements, payroll).

- Nonroutine transactions are activities that occur only periodically (for example, taking physical inventory, calculating depreciation expense, adjusting for foreign currencies). A distinguishing feature of nonroutine transactions is that data involved are generally not part of the routine flow of transactions.

- Estimation transactions are activities that involve management judgments or assumptions in formulating account balances in the absence of a precise means of measurement (for example, determining the allowance for doubtful accounts, establishing warranty reserves, assessing assets for impairment).

73. Most processes involve a series of tasks such as capturing input data, sorting and merging data, making calculations, updating transactions and master files,

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generating transactions, and summarizing and displaying or reporting data. The processing procedures relevant for the auditor to understand the flow of transactions generally are those activities required to initiate, authorize, record, process and report transactions. Such activities include, for example, initially recording sales orders, preparing shipping documents and invoices, and updating the accounts receivable master file. The relevant processing procedures also include procedures for correcting and reprocessing previously rejected transactions and for correcting erroneous transactions through adjusting journal entries.

74. For each significant process, the auditor should:

- Understand the flow of transactions, including how transactions are initiated, authorized, recorded, processed, and reported.
- Identify the points within the process at which a misstatement – including a misstatement due to fraud – related to each relevant financial statement assertion could arise.
- Identify the controls that management has implemented to address these potential misstatements.
- Identify the controls that management has implemented over the prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets.

Note: The auditor frequently obtains the understanding and identifies the controls described above as part of his or her performance of walkthroughs (as described beginning in paragraph 79).

75. The nature and characteristics of a company's use of information technology in its information system affect the company's internal control over financial reporting. AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, paragraphs .16 through .20, .30 through .32, and .77 through .79, discuss the effect of information technology on internal control over financial reporting.

76. *Understanding the Period-end Financial Reporting Process*. The period-end financial reporting process includes the following:

- The procedures used to enter transaction totals into the general ledger;

- The procedures used to initiate, authorize, record, and process journal entries in the general ledger;

- Other procedures used to record recurring and nonrecurring adjustments to the annual and quarterly financial statements, such as consolidating adjustments, report combinations, and classifications; and

- Procedures for drafting annual and quarterly financial statements and related disclosures.

77. As part of understanding and evaluating the period-end financial reporting process, the auditor should evaluate:

- The inputs, procedures performed, and outputs of the processes the company uses to produce its annual and quarterly financial statements;

- The extent of information technology involvement in each period-end financial reporting process element;

- Who participates from management;

- The number of locations involved;

- Types of adjusting entries (for example, standard, nonstandard, eliminating, and consolidating); and

- The nature and extent of the oversight of the process by appropriate parties, including management, the board of directors, and the audit committee.

78. The period-end financial reporting process is always a significant process because of its importance to financial reporting and to the auditor's opinions on internal control over financial reporting and the financial statements. The auditor's understanding of the company's period-end financial reporting process and how it

interrelates with the company's other significant processes assists the auditor in identifying and testing controls that are the most relevant to financial statement risks.

79. *Performing Walkthroughs*. The auditor should perform at least one walkthrough for each major class of transactions (as identified in paragraph 71). In a walkthrough, the auditor traces a transaction from origination through the company's information systems until it is reflected in the company's financial reports. Walkthroughs provide the auditor with evidence to:

- Confirm the auditor's understanding of the process flow of transactions;
- Confirm the auditor's understanding of the design of controls identified for all five components of internal control over financial reporting, including those related to the prevention or detection of fraud;
- Confirm that the auditor's understanding of the process is complete by determining whether all points in the process at which misstatements related to each relevant financial statement assertion that could occur have been identified;
- Evaluate the effectiveness of the design of controls; and
- Confirm whether controls have been placed in operation.

Note: The auditor can often gain an understanding of the transaction flow, identify and understand controls, and conduct the walkthrough simultaneously.

80. The auditor's walkthroughs should encompass the entire process of initiating, authorizing, recording, processing, and reporting individual transactions and controls for each of the significant processes identified, including controls intended to address the risk of fraud. During the walkthrough, at each point at which important processing procedures or controls occur, the auditor should question the company's personnel about their understanding of what is required by the company's prescribed procedures and controls and determine whether the processing procedures are performed as originally understood and on a timely basis. (Controls might not be performed regularly but still be timely.) During the walkthrough, the auditor should be alert for exceptions to the company's prescribed procedures and controls.

81. While performing a walkthrough, the auditor should evaluate the quality of the evidence obtained and perform walkthrough procedures that produce a level of evidence consistent with the objectives listed in paragraph 79. Rather than reviewing copies of documents and making inquiries of a single person at the company, the auditor should follow the process flow of actual transactions using the same documents and information technology that company personnel use and make inquiries of relevant personnel involved in significant aspects of the process or controls. To corroborate information at various points in the walkthrough, the auditor might ask personnel to describe their understanding of the previous and succeeding processing or control activities and to demonstrate what they do. In addition, inquiries should include follow-up questions that could help identify the abuse of controls or indicators of fraud. Examples of follow-up inquiries include asking personnel:

- What they do when they find an error or what they are looking for to determine if there is an error (rather than simply asking them if they perform listed procedures and controls); what kind of errors they have found; what happened as a result of finding the errors, and how the errors were resolved. If the person being interviewed has never found an error, the auditor should evaluate whether that situation is due to good preventive controls or whether the individual performing the control lacks the necessary skills.

- Whether they have ever been asked to override the process or controls, and if so, to describe the situation, why it occurred, and what happened.

82. During the period under audit, when there have been significant changes in the process flow of transactions, including the supporting computer applications, the auditor should evaluate the nature of the change(s) and the effect on related accounts to determine whether to walk through transactions that were processed both before and after the change.

Note: Unless significant changes in the process flow of transactions, including the supporting computer applications, make it more efficient for the auditor to prepare new documentation of a walkthrough, the auditor may carry his or her documentation forward each year, after updating it for any changes that have taken place.

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83. *Identifying Controls to Test*. The auditor should obtain evidence about the effectiveness of controls (either by performing tests of controls himself or herself, or by using the work of others)[14/] for all relevant assertions related to all significant accounts and disclosures in the financial statements. After identifying significant accounts, relevant assertions, and significant processes, the auditor should evaluate the following to identify the controls to be tested:

- Points at which errors or fraud could occur;
- The nature of the controls implemented by management;
- The significance of each control in achieving the objectives of the control criteria and whether more than one control achieves a particular objective or whether more than one control is necessary to achieve a particular objective; and
- The risk that the controls might not be operating effectively. Factors that affect whether the control might not be operating effectively include the following:
  - Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness;
  - Whether there have been changes in the design of controls;
  - The degree to which the control relies on the effectiveness of other controls (for example, the control environment or information technology general controls);
  - Whether there have been changes in key personnel who perform the control or monitor its performance;

[14/] See paragraphs 108 through 126 for additional direction on using the work of others.

– Whether the control relies on performance by an individual or is automated; and

– The complexity of the control.

84. The auditor should clearly link individual controls with the significant accounts and assertions to which they relate.

85. The auditor should evaluate whether to test preventive controls, detective controls, or a combination of both for individual relevant assertions related to individual significant accounts. For instance, when performing tests of preventive and detective controls, the auditor might conclude that a deficient preventive control could be compensated for by an effective detective control and, therefore, not result in a significant deficiency or material weakness. For example, a monthly reconciliation control procedure, which is a detective control, might detect an out-of-balance situation resulting from an unauthorized transaction being initiated due to an ineffective authorization procedure, which is a preventive control. When determining whether the detective control is effective, the auditor should evaluate whether the detective control is sufficient to achieve the control objective to which the preventive control relates.

Note: Because effective internal control over financial reporting often includes a combination of preventive and detective controls, the auditor ordinarily will test a combination of both.

86. The auditor should apply tests of controls to those controls that are important to achieving each control objective. It is neither necessary to test all controls nor is it necessary to test redundant controls (that is, controls that duplicate other controls that achieve the same objective and already have been tested), unless redundancy is itself a control objective, as in the case of certain computer controls.

87. Appendix B, paragraphs B1 through B17, provide additional direction to the auditor in determining which controls to test when a company has multiple locations or business units. In these circumstances, the auditor should determine significant accounts and their relevant assertions, significant processes, and major classes of transactions based on those that are relevant and significant to the consolidated financial statements. Having made those determinations in relation to the consolidated financial statements, the auditor should then apply the directions in Appendix B.

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Testing and Evaluating Design Effectiveness

88. Internal control over financial reporting is effectively designed when the controls complied with would be expected to prevent or detect errors or fraud that could result in material misstatements in the financial statements. The auditor should determine whether the company has controls to meet the objectives of the control criteria by:

- Identifying the company's control objectives in each area;
- Identifying the controls that satisfy each objective; and
- Determining whether the controls, if operating properly, can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.

89. Procedures the auditor performs to test and evaluate design effectiveness include inquiry, observation, walkthroughs, inspection of relevant documentation, and a specific evaluation of whether the controls are likely to prevent or detect errors or fraud that could result in misstatements if they are operated as prescribed by appropriately qualified persons.

90. The procedures that the auditor performs in evaluating management's assessment process and obtaining an understanding of internal control over financial reporting also provide the auditor with evidence about the design effectiveness of internal control over financial reporting.

91. The procedures the auditor performs to test and evaluate design effectiveness also might provide evidence about operating effectiveness.

Testing and Evaluating Operating Effectiveness

92. An auditor should evaluate the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and qualifications to perform the control effectively.

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93. *Nature of Tests of Controls*. Tests of controls over operating effectiveness should include a mix of inquiries of appropriate personnel, inspection of relevant documentation, observation of the company's operations, and reperformance of the application of the control. For example, the auditor might observe the procedures for opening the mail and processing cash receipts to test the operating effectiveness of controls over cash receipts. Because an observation is pertinent only at the point in time at which it is made, the auditor should supplement the observation with inquiries of company personnel and inspection of documentation about the operation of such controls at other times. These inquiries might be made concurrently with performing walkthroughs.

94. Inquiry is a procedure that consists of seeking information, both financial and nonfinancial, of knowledgeable persons throughout the company. Inquiry is used extensively throughout the audit and often is complementary to performing other procedures. Inquiries may range from formal written inquiries to informal oral inquiries.

95. Evaluating responses to inquiries is an integral part of the inquiry procedure. Examples of information that inquiries might provide include the skill and competency of those performing the control, the relative sensitivity of the control to prevent or detect errors or fraud, and the frequency with which the control operates to prevent or detect errors or fraud. Responses to inquiries might provide the auditor with information not previously possessed or with corroborative evidence. Alternatively, responses might provide information that differs significantly from other information the auditor obtains (for example, information regarding the possibility of management override of controls). In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional procedures.

96. Because inquiry alone does not provide sufficient evidence to support the operating effectiveness of a control, the auditor should perform additional tests of controls. For example, if the company implements a control activity whereby its sales manager reviews and investigates a report of invoices with unusually high or low gross margins, inquiry of the sales manager as to whether he or she investigates discrepancies would be inadequate. To obtain sufficient evidence about the operating effectiveness of the control, the auditor should corroborate the sales manager's responses by performing other procedures, such as inspecting reports or other documentation used in or generated by the performance of the control, and evaluate whether appropriate actions were taken regarding discrepancies.

97. The nature of the control also influences the nature of the tests of controls the auditor can perform. For example, the auditor might examine documents regarding controls for which documentary evidence exists. However, documentary evidence regarding some aspects of the control environment, such as management's philosophy and operating style, might not exist. In circumstances in which documentary evidence of controls or the performance of controls does not exist and is not expected to exist, the auditor's tests of controls would consist of inquiries of appropriate personnel and observation of company activities. As another example, a signature on a voucher package to indicate that the signer approved it does not necessarily mean that the person carefully reviewed the package before signing. The package may have been signed based on only a cursory review (or without any review). As a result, the quality of the evidence regarding the effective operation of the control might not be sufficiently persuasive. If that is the case, the auditor should reperform the control (for example, checking prices, extensions, and additions) as part of the test of the control. In addition, the auditor might inquire of the person responsible for approving voucher packages what he or she looks for when approving packages and how many errors have been found within voucher packages. The auditor also might inquire of supervisors whether they have any knowledge of errors that the person responsible for approving the voucher packages failed to detect.

98. *Timing of Tests of Controls*. The auditor must perform tests of controls over a period of time that is adequate to determine whether, as of the date specified in management's report, the controls necessary for achieving the objectives of the control criteria are operating effectively. The period of time over which the auditor performs tests of controls varies with the nature of the controls being tested and with the frequency with which specific controls operate and specific policies are applied. Some controls operate continuously (for example, controls over sales), while others operate only at certain times (for example, controls over the preparation of monthly or quarterly financial statements and controls over physical inventory counts).

99. The auditor's testing of the operating effectiveness of such controls should occur at the time the controls are operating. Controls "as of" a specific date encompass controls that are relevant to the company's internal control over financial reporting "as of" that specific date, even though such controls might not operate until after that specific date. For example, some controls over the period-end financial reporting process normally operate only after the "as of" date. Therefore, if controls over the

December 31, 20X4 period-end financial reporting process operate in January 20X5, the auditor should test the control operating in January 20X5 to have sufficient evidence of operating effectiveness "as of" December 31, 20X4.

100. When the auditor reports on the effectiveness of controls "as of" a specific date and obtains evidence about the operating effectiveness of controls at an interim date, he or she should determine what additional evidence to obtain concerning the operation of the control for the remaining period. In making that determination, the auditor should evaluate:

- The specific controls tested prior to the "as of" date and the results of those tests;
- The degree to which evidence about the operating effectiveness of those controls was obtained;
- The length of the remaining period; and
- The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date.

101. For controls over significant nonroutine transactions, controls over accounts or processes with a high degree of subjectivity or judgment in measurement, or controls over the recording of period-end adjustments, the auditor should perform tests of controls closer to or at the "as of" date rather than at an interim date. However, the auditor should balance performing the tests of controls closer to the "as of" date with the need to obtain sufficient evidence of operating effectiveness.

102. Prior to the date specified in management's report, management might implement changes to the company's controls to make them more effective or efficient or to address control deficiencies. In that case, the auditor might not need to evaluate controls that have been superseded. For example, if the auditor determines that the new controls achieve the related objectives of the control criteria and have been in effect for a sufficient period to permit the auditor to assess their design and operating

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effectiveness by performing tests of controls,[15] he or she will not need to evaluate the design and operating effectiveness of the superseded controls for purposes of expressing an opinion on internal control over financial reporting.

103. As discussed in paragraph 207, however, the auditor must communicate all identified significant deficiencies and material weaknesses in controls to the audit committee in writing. In addition, the auditor should evaluate how the design and operating effectiveness of the superseded controls relates to the auditor's reliance on controls for financial statement audit purposes.

104. *Extent of Tests of Controls*. Each year the auditor must obtain sufficient evidence about whether the company's internal control over financial reporting, including the controls for all internal control components, is operating effectively. This means that each year the auditor must obtain evidence about the effectiveness of controls for all relevant assertions related to all significant accounts and disclosures in the financial statements. The auditor also should vary from year to year the nature, timing, and extent of testing of controls to introduce unpredictability into the testing and respond to changes in circumstances. For example, each year the auditor might test the controls at a different interim period; increase or reduce the number and types of tests performed; or change the combination of procedures used.

105. In determining the extent of procedures to perform, the auditor should design the procedures to provide a high level of assurance that the control being tested is operating effectively. In making this determination, the auditor should assess the following factors:

- *Nature of the control*. The auditor should subject manual controls to more extensive testing than automated controls. In some circumstances, testing a single operation of an automated control may be sufficient to obtain a high level of assurance that the control operated effectively, provided that information technology general controls also are operating effectively. For manual controls, sufficient evidence about the operating

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[15] Paragraph 179 provides reporting directions in these circumstances when the auditor has not been able to obtain evidence that the new controls were appropriately designed or have been operating effectively for a sufficient period of time.

effectiveness of the controls is obtained by evaluating multiple operations of the control and the results of each operation. The auditor also should assess the complexity of the controls, the significance of the judgments that must be made in connection with their operation, and the level of competence of the person performing the controls that is necessary for the control to operate effectively. As the complexity and level of judgment increase or the level of competence of the person performing the control decreases, the extent of the auditor's testing should increase.

- *Frequency of operation*. Generally, the more frequently a manual control operates, the more operations of the control the auditor should test. For example, for a manual control that operates in connection with each transaction, the auditor should test multiple operations of the control over a sufficient period of time to obtain a high level of assurance that the control operated effectively. For controls that operate less frequently, such as monthly account reconciliations and controls over the period-end financial reporting process, the auditor may test significantly fewer operations of the control. However, the auditor's evaluation of each operation of controls operating less frequently is likely to be more extensive. For example, when evaluating the operation of a monthly exception report, the auditor should evaluate whether the judgments made with regard to the disposition of the exceptions were appropriate and adequately supported.

  Note: When sampling is appropriate and the population of controls to be tested is large, increasing the population size does not proportionately increase the required sample size.

- *Importance of the control*. Controls that are relatively more important should be tested more extensively. For example, some controls may address multiple financial statement assertions, and certain period-end detective controls might be considered more important than related preventive controls. The auditor should test more operations of such controls or, if such controls operate infrequently, the auditor should evaluate each operation of the control more extensively.

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106. *Use of Professional Skepticism when Evaluating the Results of Testing*. The auditor must conduct the audit of internal control over financial reporting and the audit of the financial statements with professional skepticism, which is an attitude that includes a questioning mind and a critical assessment of audit evidence. For example, even though a control is performed by the same employee whom the auditor believes performed the control effectively in prior periods, the control may not be operating effectively during the current period because the employee could have become complacent, distracted, or otherwise not be effectively carrying out his or her responsibilities. Also, regardless of any past experience with the entity or the auditor's beliefs about management's honesty and integrity, the auditor should recognize the possibility that a material misstatement due to fraud could be present. Furthermore, professional skepticism requires the auditor to consider whether evidence obtained suggests that a material misstatement due to fraud has occurred. In exercising professional skepticism in gathering and evaluating evidence, the auditor must not be satisfied with less-than-persuasive evidence because of a belief that management is honest.

107. When the auditor identifies exceptions to the company's prescribed control procedures, he or she should determine, using professional skepticism, the effect of the exception on the nature and extent of additional testing that may be appropriate or necessary and on the operating effectiveness of the control being tested. A conclusion that an identified exception does not represent a control deficiency is appropriate only if evidence beyond what the auditor had initially planned and beyond inquiry supports that conclusion.

Using the Work of Others

108. In all audits of internal control over financial reporting, the auditor must perform enough of the testing himself or herself so that the auditor's own work provides the principal evidence for the auditor's opinion. The auditor may, however, use the work of others to alter the nature, timing, or extent of the work he or she otherwise would have performed. For these purposes, the work of others includes relevant work performed by internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee that provides information about the effectiveness of internal control over financial reporting.

Note: Because the amount of work related to obtaining sufficient evidence to support an opinion about the effectiveness of controls is not susceptible to precise measurement, the auditor's judgment about whether he or she has obtained the principal evidence for the opinion will be qualitative as well as quantitative. For example, the auditor might give more weight to work he or she performed on pervasive controls and in areas such as the control environment than on other controls, such as controls over low-risk, routine transactions.

109. The auditor should evaluate whether to use the work performed by others in the audit of internal control over financial reporting. To determine the extent to which the auditor may use the work of others to alter the nature, timing, or extent of the work the auditor would have otherwise performed, in addition to obtaining the principal evidence for his or her opinion, the auditor should:

a. Evaluate the nature of the controls subjected to the work of others (See paragraphs 112 through 116);

b. Evaluate the competence and objectivity of the individuals who performed the work (See paragraphs 117 through 122); and

c. Test some of the work performed by others to evaluate the quality and effectiveness of their work (See paragraphs 123 through 125).

Note: AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, applies to using the work of internal auditors in an audit of the financial statements. The auditor may apply the relevant concepts described in that section to using the work of others in the audit of internal control over financial reporting.

110. The auditor must obtain sufficient evidence to support his or her opinion. Judgments about the sufficiency of evidence obtained and other factors affecting the auditor's opinion, such as the significance of identified control deficiencies, should be those of the auditor. Evidence obtained through the auditor's direct personal knowledge, observation, reperformance, and inspection is generally more persuasive than information obtained indirectly from others, such as from internal auditors, other company personnel, or third parties working under the direction of management.

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111. The requirement that the auditor's own work must provide the principal evidence for the auditor's opinion is one of the boundaries within which the auditor determines the work he or she must perform himself or herself in the audit of internal control over financial reporting. Paragraphs 112 through 125 provide more specific and definitive direction on how the auditor makes this determination, but the directions allow the auditor significant flexibility to use his or her judgment to determine the work necessary to obtain the principal evidence and to determine when the auditor can use the work of others rather than perform the work himself or herself. Regardless of the auditor's determination of the work that he or she must perform himself or herself, the auditor's responsibility to report on the effectiveness of internal control over financial reporting rests solely with the auditor; this responsibility cannot be shared with the other individuals whose work the auditor uses. Therefore, when the auditor uses the work of others, the auditor is responsible for the results of their work.

112. *Evaluating the Nature of the Controls Subjected to the Work of Others*. The auditor should evaluate the following factors when evaluating the nature of the controls subjected to the work of others. As these factors increase in significance, the need for the auditor to perform his or her own work on those controls increases. As these factors decrease in significance, the need for the auditor to perform his or her own work on those controls decreases.

- The materiality of the accounts and disclosures that the control addresses and the risk of material misstatement.
- The degree of judgment required to evaluate the operating effectiveness of the control (that is, the degree to which the evaluation of the effectiveness of the control requires evaluation of subjective factors rather than objective testing).
- The pervasiveness of the control.
- The level of judgment or estimation required in the account or disclosure.
- The potential for management override of the control.

113. Because of the nature of the controls in the control environment, the auditor should not use the work of others to reduce the amount of work he or she performs on

controls in the control environment. The auditor should, however, consider the results of work performed in this area by others because it might indicate the need for the auditor to increase his or her work.

114. The control environment encompasses the following factors:[16/]

- Integrity and ethical values;
- Commitment to competence;
- Board of directors or audit committee participation;
- Management's philosophy and operating style;
- Organizational structure;
- Assignment of authority and responsibility; and
- Human resource policies and procedures.

115. Controls that are part of the control environment include, but are not limited to, controls specifically established to prevent and detect fraud that is at least reasonably possible to result in material misstatement of the financial statements.

Note: The term "reasonably possible" has the same meaning as in FAS No. 5. See the first note to paragraph 9 for further discussion.

116. The auditor should perform the walkthroughs (as discussed beginning at paragraph 79) himself or herself because of the degree of judgment required in performing this work. However, to provide additional evidence, the auditor may also review the work of others who have performed and documented walkthroughs. In evaluating whether his or her own evidence provides the principal evidence, the

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[16/] See the COSO report and paragraph .110 of AU sec. 319, *Internal Control in a Financial Statement Audit*, for additional information about the factors included in the control environment.

auditor's work on the control environment and in performing walkthroughs constitutes an important part of the auditor's own work.

117. *Evaluating the Competence and Objectivity of Others*. The extent to which the auditor may use the work of others depends on the degree of competence and objectivity of the individuals performing the work. The higher the degree of competence and objectivity, the greater use the auditor may make of the work; conversely, the lower the degree of competence and objectivity, the less use the auditor may make of the work. Further, the auditor should not use the work of individuals who have a low degree of objectivity, regardless of their level of competence. Likewise, the auditor should not use the work of individuals who have a low level of competence regardless of their degree of objectivity.

118. When evaluating the competence and objectivity of the individuals performing the tests of controls, the auditor should obtain, or update information from prior years, about the factors indicated in the following paragraph. The auditor should determine whether to test the existence and quality of those factors and, if so, the extent to which to test the existence and quality of those factors, based on the intended effect of the work of others on the audit of internal control over financial reporting.

119. Factors concerning the competence of the individuals performing the tests of controls include:

- Their educational level and professional experience.
- Their professional certification and continuing education.
- Practices regarding the assignment of individuals to work areas.
- Supervision and review of their activities.
- Quality of the documentation of their work, including any reports or recommendations issued.
- Evaluation of their performance.

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120. Factors concerning the objectivity of the individuals performing the tests of controls include:

- The organizational status of the individuals responsible for the work of others ("testing authority") in testing controls, including—

  a. Whether the testing authority reports to an officer of sufficient status to ensure sufficient testing coverage and adequate consideration of, and action on, the findings and recommendations of the individuals performing the testing.

  b. Whether the testing authority has direct access and reports regularly to the board of directors or the audit committee.

  c. Whether the board of directors or the audit committee oversees employment decisions related to the testing authority.

- Policies to maintain the individuals' objectivity about the areas being tested, including—

  a. Policies prohibiting individuals from testing controls in areas in which relatives are employed in important or internal control-sensitive positions.

  b. Policies prohibiting individuals from testing controls in areas to which they were recently assigned or are scheduled to be assigned upon completion of their controls testing responsibilities.

121. Internal auditors normally are expected to have greater competence with regard to internal control over financial reporting and objectivity than other company personnel. Therefore, the auditor may be able to use their work to a greater extent than the work of other company personnel. This is particularly true in the case of internal auditors who follow the *International Standards for the Professional Practice of Internal Auditing* issued by the Institute of Internal Auditors. If internal auditors have performed an extensive amount of relevant work and the auditor determines they possess a high degree of competence and objectivity, the auditor could use their work to the greatest extent an auditor could use the work of others. On the other hand, if the internal audit

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function reports solely to management, which would reduce internal auditors' objectivity, or if limited resources allocated to the internal audit function result in very limited testing procedures on its part or reduced competency of the internal auditors, the auditor should use their work to a much lesser extent and perform more of the testing himself or herself.

122. When determining how the work of others will alter the nature, timing, or extent of the auditor's work, the auditor should assess the interrelationship of the nature of the controls, as discussed in paragraph 112, and the competence and objectivity of those who performed the work, as discussed in paragraphs 117 through 121. As the significance of the factors listed in paragraph 112 increases, the ability of the auditor to use the work of others decreases at the same time that the necessary level of competence and objectivity of those who perform the work increases. For example, for some pervasive controls, the auditor may determine that using the work of internal auditors to a limited degree would be appropriate and that using the work of other company personnel would not be appropriate because other company personnel do not have a high enough degree of objectivity as it relates to the nature of the controls.

123. *Testing the Work of Others*. The auditor should test some of the work of others to evaluate the quality and effectiveness of the work. The auditor's tests of the work of others may be accomplished by either (a) testing some of the controls that others tested or (b) testing similar controls not actually tested by others.

124. The nature and extent of these tests depend on the effect of the work of others on the auditor's procedures but should be sufficient to enable the auditor to make an evaluation of the overall quality and effectiveness of the work the auditor is considering. The auditor also should assess whether this evaluation has an effect on his or her conclusions about the competence and objectivity of the individuals performing the work.

125. In evaluating the quality and effectiveness of the work of others, the auditor should evaluate such factors as to whether the:

- Scope of work is appropriate to meet the objectives.

- Work programs are adequate.

- Work performed is adequately documented, including evidence of supervision and review.

- Conclusions are appropriate in the circumstances.

- Reports are consistent with the results of the work performed.

126. The following examples illustrate how to apply the directions discussed in this section:

- *Controls over the period-end financial reporting process*. Many of the controls over the period-end financial reporting process address significant risks of misstatement of the accounts and disclosures in the annual and quarterly financial statements, may require significant judgment to evaluate their operating effectiveness, may have a higher potential for management override, and may affect accounts that require a high level of judgment or estimation. Therefore, the auditor could determine that, based on the nature of controls over the period-end financial reporting process, he or she would need to perform more of the tests of those controls himself or herself. Further, because of the nature of the controls, the auditor should use the work of others only if the degree of competence and objectivity of the individuals performing the work is high; therefore, the auditor might use the work of internal auditors to some extent but not the work of others within the company.

- *Information technology general controls*. Information technology general controls are part of the control activities component of internal control; therefore, the nature of the controls might permit the auditor to use the work of others. For example, program change controls over routine maintenance changes may have a highly pervasive effect, yet involve a low degree of judgment in evaluating their operating effectiveness, can be subjected to objective testing, and have a low potential for management override. Therefore, the auditor could determine that, based on the nature of these program change controls, the auditor could use the work of others to a moderate extent so long as the degree of competence and objectivity of the individuals performing the test is at an appropriate level. On the other hand, controls to detect attempts to override controls that prevent unauthorized journal entries from being posted may have a highly pervasive effect, may involve a high degree of judgment in evaluating their operating effectiveness, may involve a subjective evaluation, and may have a reasonable possibility for management override. Therefore, the auditor could determine that, based on the nature of these controls over systems access, he or she would need to perform more of the tests of those controls himself or herself. Further, because of the nature of the controls, the auditor should use the work of others only if the degree of competence and objectivity of the individuals performing the tests is high.

- *Management self-assessment of controls*. As described in paragraph 40, management may test the operating effectiveness of controls using a self-assessment process. Because such an assessment is made by the same personnel who are responsible for performing the control, the individuals performing the self-assessment do not have sufficient objectivity as it relates to the subject matter. Therefore, the auditor should not use their work.

- *Controls over the calculation of depreciation of fixed assets*. Controls over the calculation of depreciation of fixed assets are usually not pervasive, involve a low degree of judgment in evaluating their operating effectiveness, and can be subjected to objective testing. If these conditions describe the controls over the calculation of depreciation of fixed assets and if there is a low potential for management override, the auditor could determine that, based on the nature of these controls, the auditor could use the work of others to a large extent (perhaps entirely) so long as the degree of competence and objectivity of the individuals performing the test is at an appropriate level.

- *Alternating tests of controls*. Many of the controls over accounts payable, including controls over cash disbursements, are usually not pervasive, involve a low degree of judgment in evaluating their operating effectiveness, can be subjected to objective testing, and have a low potential for management override. When these conditions describe the controls over accounts payable, the auditor could determine that, based on the nature of these controls, he or she could use the work of others to a large extent (perhaps entirely) so long as the degree of competence and objectivity of the individuals performing the test is at an appropriate level. However, if the company recently implemented a major information technology change that significantly affected controls over cash disbursements, the auditor might decide to use the work of others to a lesser extent in the audit immediately following the information technology change and then return, in subsequent years, to using the work of others to a large extent in this area. As another example, the auditor might use the work of others for testing controls over the depreciation of fixed assets (as described in the point above) for several years' audits but decide one year to perform some extent of the work himself or herself to gain an understanding of these controls beyond that provided by performing a walkthrough.

Forming an Opinion on the Effectiveness of Internal Control Over Financial Reporting

127. When forming an opinion on internal control over financial reporting, the auditor should evaluate all evidence obtained from all sources, including:

- The adequacy of the assessment performed by management and the results of the auditor's evaluation of the design and tests of operating effectiveness of controls;

- The negative results of substantive procedures performed during the financial statement audit (for example, recorded and unrecorded adjustments identified as a result of the performance of the auditing procedures); and

- Any identified control deficiencies.

128. As part of this evaluation, the auditor should review all reports issued during the year by internal audit (or similar functions, such as loan review in a financial institution) that address controls related to internal control over financial reporting and evaluate any control deficiencies identified in those reports. This review should include reports issued by internal audit as a result of operational audits or specific reviews of key processes if those reports address controls related to internal control over financial reporting.

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129. *Issuing an Unqualified Opinion*. The auditor may issue an unqualified opinion only when there are no identified material weaknesses and when there have been no restrictions on the scope of the auditor's work. The existence of a material weakness requires the auditor to express an adverse opinion on the effectiveness of internal control over financial reporting (See paragraph 175), while a scope limitation requires the auditor to express a qualified opinion or a disclaimer of opinion, depending on the significance of the limitation in scope (See paragraph 178).

130. *Evaluating Deficiencies in Internal Control Over Financial Reporting*. The auditor must evaluate identified control deficiencies and determine whether the deficiencies, individually or in combination, are significant deficiencies or material weaknesses. The evaluation of the significance of a deficiency should include both quantitative and qualitative factors.

131. The auditor should evaluate the significance of a deficiency in internal control over financial reporting initially by determining the following:

- The likelihood that a deficiency, or a combination of deficiencies, could result in a misstatement of an account balance or disclosure; and

- The magnitude of the potential misstatement resulting from the deficiency or deficiencies.

132. The significance of a deficiency in internal control over financial reporting depends on the *potential* for a misstatement, not on whether a misstatement actually has occurred.

133. Several factors affect the *likelihood* that a deficiency, or a combination of deficiencies, could result in a misstatement of an account balance or disclosure. The factors include, but are not limited to, the following:

- The nature of the financial statement accounts, disclosures, and assertions involved; for example, suspense accounts and related party transactions involve greater risk.

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- The susceptibility of the related assets or liability to loss or fraud; that is, greater susceptibility increases risk.

- The subjectivity, complexity, or extent of judgment required to determine the amount involved; that is, greater subjectivity, complexity, or judgment, like that related to an accounting estimate, increases risk.

- The cause and frequency of known or detected exceptions for the operating effectiveness of a control; for example, a control with an observed non-negligible deviation rate is a deficiency.

- The interaction or relationship of the control with other controls; that is, the interdependence or redundancy of the control.

- The interaction of the deficiencies; for example, when evaluating a combination of two or more deficiencies, whether the deficiencies could affect the same financial statement accounts and assertions.

- The possible future consequences of the deficiency.

134. When evaluating the likelihood that a deficiency or combination of deficiencies could result in a misstatement, the auditor should evaluate how the controls interact with other controls. There are controls, such as information technology general controls, on which other controls depend. Some controls function together as a group of controls. Other controls overlap, in the sense that these other controls achieve the same objective.

135. Several factors affect the magnitude of the misstatement that could result from a deficiency or deficiencies in controls. The factors include, but are not limited to, the following:

- The financial statement amounts or total of transactions exposed to the deficiency.

- The volume of activity in the account balance or class of transactions exposed to the deficiency that has occurred in the current period or that is expected in future periods.

136. In evaluating the magnitude of the potential misstatement, the auditor should recognize that the maximum amount that an account balance or total of transactions can be overstated is generally the recorded amount. However, the recorded amount is not a limitation on the amount of potential understatement. The auditor also should recognize that the risk of misstatement might be different for the maximum possible misstatement than for lesser possible amounts.

137. When evaluating the significance of a deficiency in internal control over financial reporting, the auditor also should determine the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles. If the auditor determines that the deficiency would prevent prudent officials in the conduct of their own affairs from concluding that they have reasonable assurance,[17/] then the auditor should deem the deficiency to be at least a significant deficiency. Having determined in this manner that a deficiency represents a significant deficiency, the auditor must further evaluate the deficiency to determine whether individually, or in combination with other deficiencies, the deficiency is a material weakness.

> Note: Paragraphs 9 and 10 provide the definitions of significant deficiency and material weakness, respectively.

138. Inadequate documentation of the design of controls and the absence of sufficient documented evidence to support management's assessment of the operating effectiveness of internal control over financial reporting are control deficiencies. As with other control deficiencies, the auditor should evaluate these deficiencies as to their significance.

139. The interaction of qualitative considerations that affect internal control over financial reporting with quantitative considerations ordinarily results in deficiencies in the

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[17/] See SEC Staff Accounting Bulletin Topic 1M2, *Immaterial Misstatements That Are Intentional*, for further discussion about the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs.

following areas being at least significant deficiencies in internal control over financial reporting:

- Controls over the selection and application of accounting policies that are in conformity with generally accepted accounting principles;

- Antifraud programs and controls;

- Controls over non-routine and non-systematic transactions; and

- Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; initiate, authorize, record, and process journal entries into the general ledger; and record recurring and nonrecurring adjustments to the financial statements

140. Each of the following circumstances should be regarded as at least a significant deficiency and as a strong indicator that a material weakness in internal control over financial reporting exists:

- Restatement of previously issued financial statements to reflect the correction of a misstatement.

  Note: The correction of a misstatement includes misstatements due to error or fraud; it does not include restatements to reflect a change in accounting principle to comply with a new accounting principle or a voluntary change from one generally accepted accounting principle to another generally accepted accounting principle.

- Identification by the auditor of a material misstatement in financial statements in the current period that was not initially identified by the company's internal control over financial reporting. (This is a strong indicator of a material weakness even if management subsequently corrects the misstatement.)

- Oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective.

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(Paragraphs 55 through 59 present factors to evaluate when determining whether the audit committee is ineffective.)

- The internal audit function or the risk assessment function is ineffective at a company for which such a function needs to be effective for the company to have an effective monitoring or risk assessment component, such as for very large or highly complex companies.

  Note: The evaluation of the internal audit or risk assessment functions is similar to the evaluation of the audit committee, as described in paragraphs 55 through 59, that is, the evaluation is made within the context of the monitoring and risk assessment components. The auditor is not required to make a separate evaluation of the effectiveness and performance of these functions. Instead, the auditor should base his or her evaluation on evidence obtained as part of evaluating the monitoring and risk assessment components of internal control over financial reporting.

- For complex entities in highly regulated industries, an ineffective regulatory compliance function. This relates solely to those aspects of the ineffective regulatory compliance function in which associated violations of laws and regulations could have a material effect on the reliability of financial reporting.

- Identification of fraud of any magnitude on the part of senior management.

  Note: The auditor is required to plan and perform procedures to obtain reasonable assurance that material misstatement caused by fraud is detected by the auditor. However, for the purposes of evaluating and reporting deficiencies in internal control over financial reporting, the auditor should evaluate fraud of any magnitude (including fraud resulting in immaterial misstatements) on the part of senior management of which he or she is aware. Furthermore, for the purposes of this circumstance, "senior management" includes the principal executive and financial officers signing the company's certifications as required under Section 302 of the Act as well as any other member of management who play a significant role in the company's financial reporting process.

- Significant deficiencies that have been communicated to management and the audit committee remain uncorrected after some reasonable period of time.

- An ineffective control environment.

141. Appendix D provides examples of significant deficiencies and material weaknesses.

Requirement for Written Representations

142. In an audit of internal control over financial reporting, the auditor should obtain written representations from management:

a. Acknowledging management's responsibility for establishing and maintaining effective internal control over financial reporting;

b. Stating that management has performed an assessment of the effectiveness of the company's internal control over financial reporting and specifying the control criteria;

c. Stating that management did not use the auditor's procedures performed during the audits of internal control over financial reporting or the financial statements as part of the basis for management's assessment of the effectiveness of internal control over financial reporting;

d. Stating management's conclusion about the effectiveness of the company's internal control over financial reporting based on the control criteria as of a specified date;

e. Stating that management has disclosed to the auditor all deficiencies in the design or operation of internal control over financial reporting identified as part of management's assessment, including separately disclosing to the auditor all such deficiencies that it believes to be significant deficiencies or material weaknesses in internal control over financial reporting;

f. Describing any material fraud and any other fraud that, although not material, involves senior management or management or other employees who have a significant role in the company's internal control over financial reporting;

g. Stating whether control deficiencies identified and communicated to the audit committee during previous engagements pursuant to paragraph 207 have been resolved, and specifically identifying any that have not; and

h. Stating whether there were, subsequent to the date being reported on, any changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses.

143. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion. As discussed further in paragraph 178, when management limits the scope of the audit, the auditor should either withdraw from the engagement or disclaim an opinion. Further, the auditor should evaluate the effects of management's refusal on his or her ability to rely on other representations, including, if applicable, representations obtained in an audit of the company's financial statements.

144. AU sec. 333, *Management Representations*, explains matters such as who should sign the letter, the period to be covered by the letter, and when to obtain an updating letter.

Relationship of an Audit of Internal Control over Financial Reporting to an Audit of Financial Statements

145. The audit of internal control over financial reporting should be integrated with the audit of the financial statements. The objectives of the procedures for the audits are not identical, however, and the auditor must plan and perform the work to achieve the objectives of both audits.

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146. The understanding of internal control over financial reporting the auditor obtains and the procedures the auditor performs for purposes of expressing an opinion on management's assessment are interrelated with the internal control over financial reporting understanding the auditor obtains and procedures the auditor performs to assess control risk for purposes of expressing an opinion on the financial statements. As a result, it is efficient for the auditor to coordinate obtaining the understanding and performing the procedures.

Tests of Controls in an Audit of Internal Control Over Financial Reporting

147. The objective of the tests of controls in an audit of internal control over financial reporting is to obtain evidence about the effectiveness of controls to support the auditor's opinion on whether management's assessment of the effectiveness of the company's internal control over financial reporting is fairly stated. The auditor's opinion relates to the effectiveness of the company's internal control over financial reporting as of a *point in time* and *taken as a whole*.

148. To express an opinion on internal control over financial reporting effectiveness as of a *point in time*, the auditor should obtain evidence that internal control over financial reporting has operated effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the company's financial statements. To express an opinion on internal control over financial reporting effectiveness *taken as a whole*, the auditor must obtain evidence about the effectiveness of controls over all relevant assertions related to all significant accounts and disclosures in the financial statements. This requires that the auditor test the design and operating effectiveness of controls he or she ordinarily would not test if expressing an opinion only on the financial statements.

149. When concluding on the effectiveness of internal control over financial reporting for purposes of expressing an opinion on management's assessment, the auditor should incorporate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the financial statements, as discussed in the following section.

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Tests of Controls in an Audit of Financial Statements

150. To express an opinion on the financial statements, the auditor ordinarily performs tests of controls and substantive procedures. The objective of the tests of controls the auditor performs for this purpose is to assess control risk. To assess control risk for specific financial statement assertions at less than the maximum, the auditor is required to obtain evidence that the relevant controls operated effectively during the *entire period* upon which the auditor plans to place reliance on those controls. However, the auditor is not required to assess control risk at less than the maximum for *all* relevant assertions and, for a variety of reasons, the auditor may choose not to do so.[18/]

151. When concluding on the effectiveness of controls for the purpose of assessing control risk, the auditor also should evaluate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on management's assessment, as discussed in paragraphs 147 through 149. Consideration of these results may require the auditor to alter the nature, timing, and extent of substantive procedures and to plan and perform further tests of controls, particularly in response to identified control deficiencies.

Effect of Tests of Controls on Substantive Procedures

152. Regardless of the assessed level of control risk or the assessed risk of material misstatement in connection with the audit of the financial statements, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures. Performing procedures to express an opinion on internal control over financial reporting does not diminish this requirement.

153. The substantive procedures that the auditor should perform consist of tests of details of transactions and balances and analytical procedures. Before using the results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information. For significant risks of

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[18/] See paragraph 160 for additional documentation requirements when the auditor assesses control risk as other than low.

material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.

154. When designing substantive analytical procedures, the auditor also should evaluate the risk of management override of controls. As part of this process, the auditor should evaluate whether such an override might have allowed adjustments outside of the normal period-end financial reporting process to have been made to the financial statements. Such adjustments might have resulted in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions. For this reason, substantive analytical procedures alone are not well suited to detecting fraud.

155. The auditor's substantive procedures must include reconciling the financial statements to the accounting records. The auditor's substantive procedures also should include examining material adjustments made during the course of preparing the financial statements. Also, other auditing standards require auditors to perform specific tests of details in the financial statement audit. For instance, AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to perform certain tests of details to further address the risk of management override, whether or not a specific risk of fraud has been identified. Paragraph .34 of AU Sec. 330, *The Confirmation Process*, states that there is a presumption that the auditor will request the confirmation of accounts receivable. Similarly, paragraph .01 of AU Sec. 331, *Inventories*, states that observation of inventories is a generally accepted auditing procedure and that the auditor who issues an opinion without this procedure "has the burden of justifying the opinion expressed."

156. If, during the audit of internal control over financial reporting, the auditor identifies a control deficiency, he or she should determine the effect on the nature, timing, and extent of substantive procedures to be performed to reduce the risk of material misstatement of the financial statements to an appropriately low level.

Effect of Substantive Procedures on the Auditor's Conclusions About the Operating Effectiveness of Controls

157. In an audit of internal control over financial reporting, the auditor should evaluate the effect of the findings of all substantive auditing procedures performed in the audit of

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financial statements on the effectiveness of internal control over financial reporting. This evaluation should include, but not be limited to:

- The auditor's risk evaluations in connection with the selection and application of substantive procedures, especially those related to fraud (See paragraph 26);
- Findings with respect to illegal acts and related party transactions;
- Indications of management bias in making accounting estimates and in selecting accounting principles; and
- Misstatements detected by substantive procedures. The extent of such misstatements might alter the auditor's judgment about the effectiveness of controls.

158. However, the absence of misstatements detected by substantive procedures does not provide evidence that controls related to the assertion being tested are effective.

Documentation Requirements

159. In addition to the documentation requirements in AU sec. 339, *Audit Documentation*, the auditor should document:

- The understanding obtained and the evaluation of the design of each of the five components of the company's internal control over financial reporting;
- The process used to determine significant accounts and disclosures and major classes of transactions, including the determination of the locations or business units at which to perform testing;
- The identification of the points at which misstatements related to relevant financial statement assertions could occur within significant accounts and disclosures and major classes of transactions;

- The extent to which the auditor relied upon work performed by others as well as the auditor's assessment of their competence and objectivity;

- The evaluation of any deficiencies noted as a result of the auditor's testing; and

- Other findings that could result in a modification to the auditor's report.

160. For a company that has effective internal control over financial reporting, the auditor ordinarily will be able to perform sufficient testing of controls to be able to assess control risk for all relevant assertions related to significant accounts and disclosures at a low level. If, however, the auditor assesses control risk as other than low for certain assertions or significant accounts, the auditor should document the reasons for that conclusion. Examples of when it is appropriate to assess control risk as other than low include:

- When a control over a relevant assertion related to a significant account or disclosure was superseded late in the year and only the new control was tested for operating effectiveness.

- When a material weakness existed during the period under audit and was corrected by the end of the period.

161. The auditor also should document the effect of a conclusion that control risk is other than low for any relevant assertions related to any significant accounts in connection with the audit of the financial statements on his or her opinion on the audit of internal control over financial reporting.

Reporting on Internal Control Over Financial Reporting

Management's Report

162. Management is required to include in its annual report its assessment of the effectiveness of the company's internal control over financial reporting in addition to its

audited financial statements as of the end of the most recent fiscal year. Management's report on internal control over financial reporting is required to include the following:[19/]

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company;

- A statement identifying the framework used by management to conduct the required assessment of the effectiveness of the company's internal control over financial reporting;

- An assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including an explicit statement as to whether that internal control over financial reporting is effective; and

- A statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the company's internal control over financial reporting.

163. Management should provide, both in its report on internal control over financial reporting and in its representation letter to the auditor, a written conclusion about the effectiveness of the company's internal control over financial reporting. The conclusion about the effectiveness of a company's internal control over financial reporting can take many forms; however, management is required to state a direct conclusion about whether the company's internal control over financial reporting is effective. This standard, for example, includes the phrase "management's assessment that W Company maintained effective internal control over financial reporting as of [*date*]" to illustrate such a conclusion. Other phrases, such as "management's assessment that W Company's internal control over financial reporting as of [*date*] is sufficient to meet the stated objectives," also might be used. However, the conclusion should not be so subjective (for example, "very effective internal control") that people having competence

[19/] See Item 308(a) of Regulation S-B and S-K, 17 C.F.R. 228.308(a) and 17 C.F.R. 229.308(a), respectively.

in and using the same or similar criteria would not ordinarily be able to arrive at similar conclusions.

164. Management is precluded from concluding that the company's internal control over financial reporting is effective if there are one or more material weaknesses.[20/] In addition, management is required to disclose all material weaknesses that exist as of the end of the most recent fiscal year.

165. Management might be able to accurately represent that internal control over financial reporting, as of the end of the company's most recent fiscal year, is effective even if one or more material weaknesses existed during the period. To make this representation, management must have changed the internal control over financial reporting to eliminate the material weaknesses sufficiently in advance of the "as of" date and have satisfactorily tested the effectiveness over a period of time that is adequate for it to determine whether, as of the end of the fiscal year, the design and operation of internal control over financial reporting is effective.[21/]

Auditor's Evaluation of Management's Report

166. With respect to management's report on its assessment, the auditor should evaluate the following matters:

a. Whether management has properly stated its responsibility for establishing and maintaining adequate internal control over financial reporting.

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[20] See Item 308(a)(3) of Regulation S-B and S-K, 17 C.F.R. 228.308(a) and 17 C.F.R. 229.308(a), respectively.

[21] However, when the reason for a change in internal control over financial reporting is the correction of a material weakness, management and the auditor should evaluate whether the reason for the change and the circumstances surrounding the change are material information necessary to make the disclosure about the change not misleading in a filing subject to certification under Securities Exchange Act Rule 13a-14(a) or 15d-14(a), 17 C.F.R. 240.13a-14(a) or 17 C.F.R. 240.15d-14(a). See discussion beginning at paragraph 200 for further direction.

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b. Whether the framework used by management to conduct the evaluation is suitable. (As discussed in paragraph 14, the framework described in COSO constitutes a suitable and available framework.)

c. Whether management's assessment of the effectiveness of internal control over financial reporting, as of the end of the company's most recent fiscal year, is free of material misstatement.

d. Whether management has expressed its assessment in an acceptable form.

- Management is required to state whether the company's internal control over financial reporting is effective.

- A negative assurance statement indicating that, "Nothing has come to management's attention to suggest that the company's internal control over financial reporting is not effective," is not acceptable.

- Management is not permitted to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses in the company's internal control over financial reporting.

e. Whether material weaknesses identified in the company's internal control over financial reporting, if any, have been properly disclosed, including material weaknesses corrected during the period.[22/]

[22/] See paragraph 206 for direction when a material weakness was corrected during the fourth quarter and the auditor believes that modification to the disclosures about changes in internal control over financial reporting are necessary for the annual certifications to be accurate and to comply with the requirements of Section 302 of the Act.

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Auditor's Report on Management's Assessment of Internal Control Over Financial Reporting

167. The auditor's report on management's assessment of the effectiveness of internal control over financial reporting must include the following elements:

a. A title that includes the word *independent*;

b. An identification of management's conclusion about the effectiveness of the company's internal control over financial reporting as of a specified date based on the control criteria [for example, criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)];

c. An identification of the title of the management report that includes management's assessment (the auditor should use the same description of the company's internal control over financial reporting as management uses in its report);

d. A statement that the assessment is the responsibility of management;

e. A statement that the auditor's responsibility is to express an opinion on the assessment and an opinion on the company's internal control over financial reporting based on his or her audit;

f. A definition of internal control over financial reporting as stated in paragraph 7;

g. A statement that the audit was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States);

h. A statement that the standards of the Public Company Accounting Oversight Board require that the auditor plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects;

i. A statement that an audit includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as the auditor considered necessary in the circumstances;

j. A statement that the auditor believes the audit provides a reasonable basis for his or her opinions;

k. A paragraph stating that, because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate;

l. The auditor's opinion on whether management's assessment of the effectiveness of the company's internal control over financial reporting as of the specified date is fairly stated, in all material respects, based on the control criteria (See discussion beginning at paragraph 162);

m. The auditor's opinion on whether the company maintained, in all material respects, effective internal control over financial reporting as of the specified date, based on the control criteria;

n. The manual or printed signature of the auditor's firm;

o. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued; and

p. The date of the audit report.

168. Example A-1 in Appendix A is an illustrative auditor's report for an unqualified opinion on management's assessment of the effectiveness of the company's internal control over financial reporting and an unqualified opinion on the effectiveness of the company's internal control over financial reporting.

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169. *Separate or Combined Reports*. The auditor may choose to issue a combined report (that is, one report containing both an opinion on the financial statements and the opinions on internal control over financial reporting) or separate reports on the company's financial statements and on internal control over financial reporting. Example A-7 in Appendix A is an illustrative combined audit report on internal control over financial reporting. Appendix A also includes examples of separate reports on internal control over financial reporting.

170. If the auditor chooses to issue a separate report on internal control over financial reporting, he or she should add the following paragraph to the auditor's report on the financial statements:

> We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of W Company's internal control over financial reporting as of December 31, 20X3, based on [*identify control criteria*] and our report dated [*date of report, which should be the same as the date of the report on the financial statements*] expressed [*include nature of opinions*].

and add the following paragraph to the report on internal control over financial reporting:

> We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting*] expressed [*include nature of opinion*].

171. *Report Date*. As stated previously, the auditor cannot audit internal control over financial reporting without also auditing the financial statements. Therefore, the reports should be dated the same.

172. When the auditor elects to issue a combined report on the audit of the financial statements and the audit of internal control over financial reporting, the audit opinion will address multiple reporting periods for the financial statements presented but only the end of the most recent fiscal year for the effectiveness of internal control over financial reporting and management's assessment of the effectiveness of internal control over financial reporting. See a combined report in Example A-7 in Appendix A.

173. *Report Modifications*. The auditor should modify the standard report if any of the following conditions exist.

a. Management's assessment is inadequate or management's report is inappropriate. (See paragraph 174.)

b. There is a material weakness in the company's internal control over financial reporting. (See paragraphs 175 through 177.)

c. There is a restriction on the scope of the engagement. (See paragraphs 178 through 181.)

d. The auditor decides to refer to the report of other auditors as the basis, in part, for the auditor's own report. (See paragraphs 182 through 185.)

e. A significant subsequent event has occurred since the date being reported on. (See paragraphs 186 through 189.)

f. There is other information contained in management's report on internal control over financial reporting. (See paragraphs 190 through 192.)

174. *Management's Assessment Inadequate or Report Inappropriate*. If the auditor determines that management's process for assessing internal control over financial reporting is inadequate, the auditor should modify his or her opinion for a scope limitation (discussed further beginning at paragraph 178). If the auditor determines that management's report is inappropriate, the auditor should modify his or her report to include, at a minimum, an explanatory paragraph describing the reasons for this conclusion.

175. *Material Weaknesses*. Paragraphs 130 through 141 describe significant deficiencies and material weaknesses. If there are significant deficiencies that, individually or in combination, result in one or more material weaknesses, management is precluded from concluding that internal control over financial reporting is effective. In these circumstances, the auditor must express an adverse opinion on the company's internal control over financial reporting.

176. When expressing an adverse opinion on the effectiveness of internal control over financial reporting because of a material weakness, the auditor's report must include:

- The definition of a material weakness, as provided in paragraph 10.

- A statement that a material weakness has been identified and included in management's assessment. (If the material weakness has not been included in management's assessment, this sentence should be modified to state that the material weakness has been identified but not included in management's assessment. In this case, the auditor also is required to communicate in writing to the audit committee that the material weakness was not disclosed or identified as a material weakness in management's report.)

- A description of any material weaknesses identified in a company's internal control over financial reporting. This description should provide the users of the audit report with specific information about the nature of any material weakness, and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness. This description also should address requirements described in paragraph 194.

177. Depending on the circumstances, the auditor may express both an unqualified opinion and an other-than-unqualified opinion within the same report on internal control over financial reporting. For example, if management makes an adverse assessment because a material weakness has been identified and not corrected ("…internal control over financial reporting is not effective…"), the auditor would express an unqualified opinion on management's assessment ("…management's assessment that internal control over financial reporting is not effective is fairly stated, in all material respects…"). At the same time, the auditor would express an adverse opinion about the effectiveness of internal control over financial reporting ("In our opinion, because of the effect of the material weakness described…, the company's internal control over financial reporting is not effective."). Example A-2 in Appendix A illustrates the form of the report that is appropriate in this situation. Example A-6 in Appendix A illustrates a report that reflects disagreement between management and the auditor that a material weakness exists.

178. *Scope Limitations*. The auditor can express an unqualified opinion on management's assessment of internal control over financial reporting and an unqualified opinion on the effectiveness of internal control over financial reporting only if the auditor has been able to apply all the procedures necessary in the circumstances. If there are restrictions on the scope of the engagement imposed by the circumstances, the auditor should withdraw from the engagement, disclaim an opinion, or express a qualified opinion. The auditor's decision depends on his or her assessment of the importance of the omitted procedure(s) to his or her ability to form an opinion on management's assessment of internal control over financial reporting and an opinion on the effectiveness of the company's internal control over financial reporting. However, when the restrictions are imposed by management, the auditor should withdraw from the engagement or disclaim an opinion on management's assessment of internal control over financial reporting and the effectiveness of internal control over financial reporting.

179. For example, management might have identified a material weakness in its internal control over financial reporting prior to the date specified in its report and implemented controls to correct it. If management believes that the new controls have been operating for a sufficient period of time to determine that they are both effectively designed and operating, management would be able to include in its assessment its conclusion that internal control over financial reporting is effective as of the date specified. However, if the auditor disagrees with the sufficiency of the time period, he or she would be unable to obtain sufficient evidence that the new controls have been operating effectively for a sufficient period. In that case, the auditor should modify the opinion on the effectiveness of internal control over financial reporting and the opinion on management's assessment of internal control over financial reporting because of a scope limitation.

180. When the auditor plans to disclaim an opinion and the limited procedures performed by the auditor caused the auditor to conclude that a material weakness exists, the auditor's report should include:

- The definition of a material weakness, as provided in paragraph 10.

- A description of any material weaknesses identified in the company's internal control over financial reporting. This description should provide the users of the audit report with specific information about the nature of any material weakness, and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness. This description also should address the requirements in paragraph 194.

181. Example A-3 in Appendix A illustrates the form of report when there is a limitation on the scope of the audit causing the auditor to issue qualified opinions. Example A-4 illustrates the form of report when restrictions on the scope of the audit cause the auditor to disclaim opinions.

182. *Opinions Based, in Part, on the Report of Another Auditor*. When another auditor has audited the financial statements and internal control over financial reporting of one or more subsidiaries, divisions, branches, or components of the company, the auditor should determine whether he or she may serve as the principal auditor and use the work and reports of another auditor as a basis, in part, for his or her opinions. AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, provides direction on the auditor's decision of whether to serve as the principal auditor of the financial statements. If the auditor decides it is appropriate to serve as the principal auditor of the financial statements, then that auditor also should be the principal auditor of the company's internal control over financial reporting. This relationship results from the requirement that an audit of the financial statements must be performed to audit internal control over financial reporting; only the principal auditor of the financial statements can be the principal auditor of internal control over financial reporting. In this circumstance, the principal auditor of the financial statements needs to participate sufficiently in the audit of internal control over financial reporting to provide a basis for serving as the principal auditor of internal control over financial reporting.

183. When serving as the principal auditor of internal control over financial reporting, the auditor should decide whether to make reference in the report on internal control over financial reporting to the audit of internal control over financial reporting performed by the other auditor. In these circumstances, the auditor's decision is based on factors similar to those of the independent auditor who uses the work and reports of other independent auditors when reporting on a company's financial statements as described in AU sec. 543.

184. The decision about whether to make reference to another auditor in the report on the audit of internal control over financial reporting might differ from the corresponding decision as it relates to the audit of the financial statements. For example, the audit

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report on the financial statements may make reference to the audit of a significant equity investment performed by another independent auditor, but the report on internal control over financial reporting might not make a similar reference because management's evaluation of internal control over financial reporting ordinarily would not extend to controls at the equity method investee.[23/]

185. When the auditor decides to make reference to the report of the other auditor as a basis, in part, for his or her opinions, the auditor should refer to the report of the other auditor when describing the scope of the audit and when expressing the opinions.

186. *Subsequent Events*. Changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting might occur subsequent to the date as of which internal control over financial reporting is being audited but before the date of the auditor's report. The auditor should inquire of management whether there were any such changes or factors. As described in paragraph 142, the auditor should obtain written representations from management relating to such matters. Additionally, to obtain information about whether changes have occurred that might affect the effectiveness of the company's internal control over financial reporting and, therefore, the auditor's report, the auditor should inquire about and examine, for this subsequent period, the following:

- Relevant internal audit reports (or similar functions, such as loan review in a financial institution) issued during the subsequent period;
- Independent auditor reports (if other than the auditor's) of significant deficiencies or material weaknesses;
- Regulatory agency reports on the company's internal control over financial reporting; and
- Information about the effectiveness of the company's internal control over financial reporting obtained through other engagements.

[23/] See Appendix B, paragraph B15, for further discussion of the evaluation of the controls over financial reporting for an equity method investment.

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187. The auditor could inquire about and examine other documents for the subsequent period. Paragraphs .01 through .09 of AU sec. 560, *Subsequent Events*, provides direction on subsequent events for a financial statement audit that also may be helpful to the auditor performing an audit of internal control over financial reporting.

188. If the auditor obtains knowledge about subsequent events that materially and adversely affect the effectiveness of the company's internal control over financial reporting as of the date specified in the assessment, the auditor should issue an adverse opinion on the effectiveness of internal control over financial reporting (and issue an adverse opinion on management's assessment of internal control over financial reporting if management's report does not appropriately assess the affect of the subsequent event). If the auditor is unable to determine the effect of the subsequent event on the effectiveness of the company's internal control over financial reporting, the auditor should disclaim opinions. As described in paragraph 190, the auditor should disclaim an opinion on management's disclosures about corrective actions taken by the company after the date of management's assessment, if any.

189. The auditor may obtain knowledge about subsequent events with respect to conditions that did not exist at the date specified in the assessment but arose subsequent to that date. If a subsequent event of this type has a material effect on the company, the auditor should include in his or her report an explanatory paragraph describing the event and its effects or directing the reader's attention to the event and its effects as disclosed in management's report. Management's consideration of such events to be disclosed in its report should be limited to a change that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

190. *Management's Report Containing Additional Information*. Management's report on internal control over financial reporting may contain information in addition to management's assessment of the effectiveness of its internal control over financial reporting. Such information might include, for example:

- Disclosures about corrective actions taken by the company after the date of management's assessment;

- The company's plans to implement new controls; and

- A statement that management believes the cost of correcting a material weakness would exceed the benefits to be derived from implementing new controls.

191. If management's assessment includes such additional information, the auditor should disclaim an opinion on the information. For example, the auditor should use the following language as the last paragraph of the report to disclaim an opinion on management's cost-benefit statement:

> We do not express an opinion or any other form of assurance on management's statement referring to the costs and related benefits of implementing new controls.

192. If the auditor believes that management's additional information contains a material misstatement of fact, he or she should discuss the matter with management. If the auditor concludes that there is a valid basis for concern, he or she should propose that management consult with some other party whose advice might be useful, such as the company's legal counsel. If, after discussing the matter with management and those management has consulted, the auditor concludes that a material misstatement of fact remains, the auditor should notify management and the audit committee, in writing, of the auditor's views concerning the information. The auditor also should consider consulting the auditor's legal counsel about further actions to be taken, including the auditor's responsibility under Section 10A of the Securities Exchange Act of 1934.[24/]

> Note: If management makes the types of disclosures described in paragraph 190 outside its report on internal control over financial reporting and includes them elsewhere within its annual report on the company's financial statements, the auditor would not need to disclaim an opinion, as described in paragraph 191. However, in that situation, the auditor's responsibilities are the same as those described in paragraph 192 if the auditor believes that the additional information contains a material misstatement of fact.

193. *Effect of Auditor's Adverse Opinion on Internal Control Over Financial Reporting on the Opinion on Financial Statements*. In some cases, the auditor's report on internal

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[24/] See Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. 78j-1.

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control over financial reporting might describe a material weakness that resulted in an adverse opinion on the effectiveness of internal control over financial reporting while the audit report on the financial statements remains unqualified. Consequently, during the audit of the financial statements, the auditor did not rely on that control. However, he or she performed additional substantive procedures to determine whether there was a material misstatement in the account related to the control. If, as a result of these procedures, the auditor determines that there was not a material misstatement in the account, he or she would be able to express an unqualified opinion on the financial statements.

194. When the auditor's opinion on the financial statements is unaffected by the adverse opinion on the effectiveness of internal control over financial reporting, the report on internal control over financial reporting (or the combined report, if a combined report is issued) should include the following or similar language in the paragraph that describes the material weakness:

> This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 20X3 financial statements, and this report does not affect our report dated [*date of report*] on those financial statements. [*Revise this wording appropriately for use in a combined report*.]

195. Such disclosure is important to ensure that users of the auditor's report on the financial statements understand why the auditor issued an unqualified opinion on those statements.

196. Disclosure is also important when the auditor's opinion on the financial statements is affected by the adverse opinion on the effectiveness of internal control over financial reporting. In that circumstance, the report on internal control over financial reporting (or the combined report, if a combined report is issued) should include the following or similar language in the paragraph that describes the material weakness:

> This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 20X3 financial statements.

197. *Subsequent Discovery of Information Existing at the Date of the Auditor's Report on Internal Control Over Financial Reporting*. After the issuance of the report on

internal control over financial reporting, the auditor may become aware of conditions that existed at the report date that might have affected the auditor's opinions had he or she been aware of them. The auditor's evaluation of such subsequent information is similar to the auditor's evaluation of information discovered subsequent to the date of the report on an audit of financial statements, as described in AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*. That standard requires the auditor to determine whether the information is reliable and whether the facts existed at the date of his or her report. If so, the auditor should determine (1) whether the facts would have changed the report if he or she had been aware of them and (2) whether there are persons currently relying on or likely to rely on the auditor's report. For instance, if previously issued financial statements and the auditor's report have been recalled and reissued to reflect the correction of a misstatement, the auditor should presume that his or her report on the company's internal control over financial reporting as of same specified date also should be recalled and reissued to reflect the material weakness that existed at that date. Based on these considerations, paragraph .06 of AU sec. 561 provides detailed requirements for the auditor.

198. *Filings Under Federal Securities Statutes*. AU sec. 711, *Filings Under Federal Securities Statutes*, describes the auditor's responsibilities when an auditor's report is included in registration statements, proxy statements, or periodic reports filed under the federal securities statutes. The auditor should also apply AU sec. 711 with respect to the auditor's report on management's assessment of the effectiveness of internal control over financial reporting included in such filings. In addition, the direction in paragraph .10 of AU sec. 711 to inquire of and obtain written representations from officers and other executives responsible for financial and accounting matters about whether any events have occurred that have a material effect on the audited financial statements should be extended to matters that could have a material effect on management's assessment of internal control over financial reporting.

199. When the auditor has fulfilled these responsibilities and intends to consent to the inclusion of his or her report on management's assessment of the effectiveness of internal control over financial reporting in the securities filing, the auditor's consent should clearly indicate that both the audit report on financial statements and the audit report on management's assessment of the effectiveness of internal control over financial reporting (or both opinions if a combined report is issued) are included in his or her consent.

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Auditor's Responsibilities for Evaluating Management's Certification Disclosures About Internal Control Over Financial Reporting

Required Management Certifications

200. Section 302 of the Act, and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies,[25/] requires a company's management, with the participation of the principal executive and financial officers (the certifying officers), to make the following quarterly and annual certifications with respect to the company's internal control over financial reporting:

- A statement that the certifying officers are responsible for establishing and maintaining internal control over financial reporting;

- A statement that the certifying officers have designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under their supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles; and

- A statement that the report discloses any changes in the company's internal control over financial reporting that occurred during the most recent fiscal quarter (the company's fourth fiscal quarter in the case of an annual report) that have materially affected, or are reasonably likely to materially affect, the company's internal control over financial reporting.

201. When the reason for a change in internal control over financial reporting is the correction of a material weakness, management has a responsibility to determine and the auditor should evaluate whether the reason for the change and the circumstances surrounding that change are material information necessary to make the disclosure about the change not misleading.[26/]

25/ See 17 C.F.R., 240.13a-14a or 15d-14a, whichever applies.

26/ See Securities Exchange Act Rule 12b-20, 17 C.F.R. 240.12b-20.

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Auditor Evaluation Responsibilities

202. The auditor's responsibility as it relates to management's quarterly certifications on internal control over financial reporting is different from the auditor's responsibility as it relates to management's annual assessment of internal control over financial reporting. The auditor should perform limited procedures quarterly to provide a basis for determining whether he or she has become aware of any material modifications that, in the auditor's judgment, should be made to the disclosures about changes in internal control over financial reporting in order for the certifications to be accurate and to comply with the requirements of Section 302 of the Act.

203. To fulfill this responsibility, the auditor should perform, on a quarterly basis, the following procedures:

- Inquire of management about significant changes in the design or operation of internal control over financial reporting as it relates to the preparation of annual as well as interim financial information that could have occurred subsequent to the preceding annual audit or prior review of interim financial information;
- Evaluate the implications of misstatements identified by the auditor as part of the auditor's required review of interim financial information (See AU sec. 722, *Interim Financial Information*) as it relates to effective internal control over financial reporting; and
- Determine, through a combination of observation and inquiry, whether any change in internal control over financial reporting has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

Note: Foreign private issuers filing Forms 20-F and 40-F are not subject to quarterly reporting requirements, therefore, the auditor's responsibilities would extend only to the certifications in the annual report of these companies.

204. When matters come to auditor's attention that lead him or her to believe that modification to the disclosures about changes in internal control over financial reporting is necessary for the certifications to be accurate and to comply with the requirements of

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Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies,[27/] the auditor should communicate the matter(s) to the appropriate level of management as soon as practicable.

205. If, in the auditor's judgment, management does not respond appropriately to the auditor's communication within a reasonable period of time, the auditor should inform the audit committee. If, in the auditor's judgment, the audit committee does not respond appropriately to the auditor's communication within a reasonable period of time, the auditor should evaluate whether to resign from the engagement. The auditor should evaluate whether to consult with his or her attorney when making these evaluations. In these circumstances, the auditor also has responsibilities under AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934.[28/] The auditor's responsibilities for evaluating the disclosures about changes in internal control over financial reporting do not diminish in any way management's responsibility for ensuring that its certifications comply with the requirements of Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies.[29/]

206. If matters come to the auditor's attention as a result of the audit of internal control over financial reporting that lead him or her to believe that modifications to the disclosures about changes in internal control over financial reporting (addressing changes in internal control over financial reporting occurring during the fourth quarter) are necessary for the annual certifications to be accurate and to comply with the requirements of Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies,[30/] the auditor should follow the same communication responsibilities as described in paragraphs 204 and 205. However, if management and the audit committee do not respond appropriately, in addition to the responsibilities

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27/ See 17 C.F.R. 240.13a-14(a) or 17 C.F.R. 240.15d-14(a), whichever applies.

28/ See 15 U.S.C. 78j-1.

29/ See 17 C.F.R. 240.13a-14(a) or 17 C.F.R. 240.15d-14(a), whichever applies.

30/ See 17 C.F.R. 240.13a-14(a) or 17 C.F.R. 240.15d-14(a), whichever applies.

described in the preceding two paragraphs, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons the auditor believes management's disclosures should be modified.

Required Communications in An Audit of Internal Control Over Financial Reporting

207. The auditor must communicate in writing to management and the audit committee all significant deficiencies and material weaknesses identified during the audit. The written communication should be made prior to the issuance of the auditor's report on internal control over financial reporting. The auditor's communication should distinguish clearly between those matters considered to be significant deficiencies and those considered to be material weaknesses, as defined in paragraphs 9 and 10, respectively.

208. If a significant deficiency or material weakness exists because the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that specific significant deficiency or material weakness in writing to the board of directors.

209. In addition, the auditor should communicate to management, in writing, all deficiencies in internal control over financial reporting (that is, those deficiencies in internal control over financial reporting that are of a lesser magnitude than significant deficiencies) identified during the audit and inform the audit committee when such a communication has been made. When making this communication, it is not necessary for the auditor to repeat information about such deficiencies that have been included in previously issued written communications, whether those communications were made by the auditor, internal auditors, or others within the organization. Furthermore, the auditor is not required to perform procedures sufficient to identify all control deficiencies; rather, the auditor should communicate deficiencies in internal control over financial reporting of which he or she is aware.

> Note: As part of his or her evaluation of the effectiveness of internal control over financial reporting, the auditor should determine whether control deficiencies identified by internal auditors and others within the company, for example, through ongoing monitoring activities and the annual assessment of internal

control over financial reporting, are reported to appropriate levels of management in a timely manner. The lack of an internal process to report deficiencies in internal control to management on a timely basis represents a control deficiency that the auditor should evaluate as to severity.

210. These written communications should state that the communication is intended solely for the information and use of the board of directors, audit committee, management, and others within the organization. When there are requirements established by governmental authorities to furnish such reports, specific reference to such regulatory agencies may be made.

211. These written communications also should include the definitions of control deficiencies, significant deficiencies, and material weaknesses and should clearly distinguish to which category the deficiencies being communicated relate.

212. Because of the potential for misinterpretation of the limited degree of assurance associated with the auditor issuing a written report representing that no significant deficiencies were noted during an audit of internal control over financial reporting, the auditor should not issue such representations.

213. When auditing internal control over financial reporting, the auditor may become aware of fraud or possible illegal acts. If the matter involves fraud, it must be brought to the attention of the appropriate level of management. If the fraud involves senior management, the auditor must communicate the matter directly to the audit committee as described in AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*. If the matter involves possible illegal acts, the auditor must assure himself or herself that the audit committee is adequately informed, unless the matter is clearly inconsequential, in accordance with AU sec. 317, *Illegal Acts by Clients*. The auditor also must determine his or her responsibilities under Section 10A of the Securities Exchange Act of 1934.[31/]

214. When timely communication is important, the auditor should communicate the preceding matters during the course of the audit rather than at the end of the engagement. The decision about whether to issue an interim communication should be

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[31/] See 15 U.S.C. 78j-1.

determined based on the relative significance of the matters noted and the urgency of corrective follow-up action required.

Effective Date

215. Companies considered *accelerated filers* under Securities Exchange Act Rule 12b-2[32/] are required to comply with the internal control reporting and disclosure requirements of Section 404 of the Act *for fiscal years ending on or after November 15, 2004*. (Other companies have until fiscal years ending on or after July 15, 2005, to comply with these internal control reporting and disclosure requirements.) Accordingly, independent auditors engaged to audit the financial statements of accelerated filers for fiscal years ending on or after November 15, 2004, also are required to audit and report on the company's internal control over financial reporting as of the end of such fiscal year. This standard is required to be complied with for such engagements, except as it relates to the auditor's responsibilities for evaluating management's certification disclosures about internal control over financial reporting. The auditor's responsibilities for evaluating management's certification disclosures about internal control over financial reporting described in paragraphs 202 through 206 take effect beginning with the first quarter after the auditor's first audit report on the company's internal control over financial reporting.

216. Early compliance with this standard is permitted.

[32/] See 17 C.F.R. 240.12b-2.

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APPENDIX A

Illustrative Reports on Internal Control Over Financial Reporting

A1. Paragraphs 167 through 199 of this standard provide direction on the auditor's report on management's assessment of internal control over financial reporting. The following examples illustrate how to apply that direction in several different situations.

ILLUSTRATIVE REPORT **PAGE**

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Example A-1

ILLUSTRATIVE REPORT EXPRESSING AN UNQUALIFIED OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING AND AN UNQUALIFIED OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING (SEPARATE REPORT)[1/]

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We have audited management's assessment, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

[*Scope paragraph*]

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we

[1/] If the auditor issues separate reports on the audit of internal control over financial reporting and the audit of the financial statements, both reports should include a statement that the audit was conducted in accordance with standards of the Public Company Accounting Oversight Board (United States).

considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, management's assessment that W Company maintained effective internal control over financial reporting as of December 31, 20X3, is fairly stated, in all material respects, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. Also in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example,* *"criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Explanatory paragraph*]

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting*] expressed [*include nature of opinion*].

[*Signature*]

[*City and State or Country*]

[*Date*]

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Example A-2

ILLUSTRATIVE REPORT EXPRESSING AN UNQUALIFIED OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING AND AN ADVERSE OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING BECAUSE OF THE EXISTENCE OF A MATERIAL WEAKNESS

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We have audited management's assessment, included in the accompanying [*title of management's report*], that W Company did not maintain effective internal control over financial reporting as of December 31, 20X3, because of the effect of [*material weakness identified in management's assessment*], based on [*Identify criteria,* f*or example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

[*Scope paragraph*]

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

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[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Explanatory paragraph*]

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weakness has been identified and included in management's assessment. [*Include a description of the material weakness and its effect on the achievement of the objectives of the control criteria.*] This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 20X3 financial statements, and this report does not affect our report dated [*date of report, which should*

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be the same as the date of this report on internal control] on those financial statements.[1/]

[*Opinion paragraph*]

In our opinion, management's assessment that W Company did not maintain effective internal control over financial reporting as of December 31, 20X3, is fairly stated, in all material respects, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. Also, in our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, W Company has not maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Signature*]

[*City and State or Country*]

[*Date*]

[1/] Modify this sentence when the auditor's opinion on the financial statements is affected by the adverse opinion on the effectiveness of internal control over financial reporting, as described in paragraph 196.

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Example A-3

ILLUSTRATIVE REPORT EXPRESSING A QUALIFIED OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING AND A QUALIFIED OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING BECAUSE OF A LIMITATION ON THE SCOPE OF THE AUDIT

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We have audited management's assessment, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

[*Scope paragraph*]

Except as described below, we conducted our audit in accordance the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

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[*Explanatory paragraph that describes scope limitation*]

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weakness has been identified and included in management's assessment.[1/] Prior to December 20, 20X3, W Company had an inadequate system for recording cash receipts, which could have prevented the Company from recording cash receipts on accounts receivable completely and properly. Therefore, cash received could have been diverted for unauthorized use, lost, or otherwise not properly recorded to accounts receivable. We believe this condition was a material weakness in the design or operation of the internal control of W Company in effect prior to December 20, 20X3. Although the Company implemented a new cash receipts system on December 20, 20X3, the system has not been in operation for a sufficient period of time to enable us to obtain sufficient evidence about its operating effectiveness.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[1/] If the auditor has identified a material weakness that is not included in management's assessment, add the following wording to the report: "In addition, we have identified the following material weakness that has not been identified as a material weakness in management's assessment."

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, except for the effect of matters we might have discovered had we been able to examine evidence about the effectiveness of the new cash receipts system, management's assessment that W Company maintained effective internal control over financial reporting as of December 31, 20X3, is fairly stated, in all material respects, based on [*Identify control criteria,* f*or example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. Also, in our opinion, except for the effect of matters we might have discovered had we been able to examine evidence about the effectiveness of the new cash receipts system, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Explanatory paragraph*]

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting*] expressed [*include nature of opinion*].

[*Signature*]

[*City and State or Country*]

[*Date*]

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Example A-4

ILLUSTRATIVE REPORT DISCLAIMING AN OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING AND DISCLAIMING AN OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING BECAUSE OF A LIMITATION ON THE SCOPE OF THE AUDIT

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We were engaged to audit management's assessment included in the accompanying [*title of management's report*] that W Company maintained effective internal control over financial reporting as of December 31, 20X3 based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting.

[*Omit scope paragraph*]

[*Explanatory paragraph that describes scope limitation*][1/]

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes

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1/ If, through the limited procedures performed, the auditor concludes that a material weakness exists, the auditor should add the definition of material weakness (as provided in paragraph 10) to the explanatory paragraph. In addition, the auditor should include a description of the material weakness and its effect on the achievement of the objectives of the control criteria.

those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

Since management [*describe scope restrictions*] and we were unable to apply other procedures to satisfy ourselves as to the effectiveness of the company's internal control over financial reporting, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion either on management's assessment or on the effectiveness of the company's internal control over financial reporting.

[*Explanatory paragraph*]

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting*] expressed [*include nature of opinion*].

[*Signature*]

[*City and State or Country*]

[*Date*]

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Example A-5

ILLUSTRATIVE REPORT EXPRESSING AN UNQUALIFIED OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING THAT REFERS TO THE REPORT OF OTHER AUDITORS AS A BASIS, IN PART, FOR THE AUDITOR'S OPINION AND AN UNQUALIFIED OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We have audited management's assessment, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit. We did not examine the effectiveness of internal control over financial reporting of B Company, a wholly owned subsidiary, whose financial statements reflect total assets and revenues constituting 20 and 30 percent, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 20X3. The effectiveness of B Company's internal control over financial reporting was audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the effectiveness of B Company's internal control over financial reporting, is based solely on the report of the other auditors.

[*Scope paragraph*]

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal

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control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit and the report of the other auditors provide a reasonable basis for our opinion.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, based on our audit and the report of the other auditors, management's assessment that W Company maintained effective internal control over financial reporting as of December 31, 20X3, is fairly stated, in all material respects, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated*

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Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."]. Also, in our opinion, based on our audit and the report of the other auditors, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Explanatory paragraph*]

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting*] expressed [*include nature of opinion*].

[*Signature*]

[*City and State or Country*]

[*Date*]

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Public Company Accounting Oversight Board

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Example A-6

ILLUSTRATIVE REPORT EXPRESSING AN ADVERSE OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING AND AN ADVERSE OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING BECAUSE OF THE EXISTENCE OF A MATERIAL WEAKNESS

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We have audited management's assessment, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

[*Scope paragraph*]

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

RELEASE

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Explanatory paragraph*]

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. We have identified the following material weakness that has not been identified as a material weakness in management's assessment [*Include a description of the material weakness and its effect on the achievement of the objectives of the control criteria.*] This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 20X3 financial statements, and this report does not affect our report dated [*date of report, which should be the same as the date of this report on internal control*] on those financial statements.[1/]

[*Opinion paragraph*]

In our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, management's assessment that W Company maintained effective internal control over financial reporting as of December 31, 20X3, is not fairly stated, in all material respects, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. Also, in our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, W Company has not maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Signature*]

[*City and State or Country*]

[*Date*]

[1/] Modify this sentence when the auditor's opinion on the financial statements is affected by the adverse opinion on the effectiveness of internal control over financial reporting.

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Example A-7

ILLUSTRATIVE COMBINED REPORT EXPRESSING AN UNQUALIFIED OPINION ON FINANCIAL STATEMENTS, AN UNQUALIFIED OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING AND AN UNQUALIFIED OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We have audited the accompanying balance sheets of W Company as of December 31, 20X3 and 20X2, and the related statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 20X3. We also have audited management's assessment, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these financial statements, an opinion on management's assessment, and an opinion on the effectiveness of the company's internal control over financial reporting based on our audits.

[*Scope paragraph*]

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of W Company as of December 31, 20X3 and 20X2, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 20X3 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, management's

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assessment that W Company maintained effective internal control over financial reporting as of December 31, 20X3, is fairly stated, in all material respects, based on [*Identify control criteria,* f*or example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. Furthermore, in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria,* f*or example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Signature*]

[*City and State or Country*]

[*Date*]

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APPENDIX B

Additional Performance Requirements and Directions; Extent-of-Testing Examples

Tests to be Performed When a Company Has Multiple Locations or Business Units

B1. To determine the locations or business units for performing audit procedures, the auditor should evaluate their relative financial significance and the risk of material misstatement arising from them. In making this evaluation, the auditor should identify the locations or business units that are individually important, evaluate their documentation of controls, and test controls over significant accounts and disclosures. For locations or business units that contain specific risks that, by themselves, could create a material misstatement, the auditor should evaluate their documentation of controls and test controls over the specific risks.

B2. The auditor should determine the other locations or business units that, when aggregated, represent a group with a level of financial significance that could create a material misstatement in the financial statements. For that group, the auditor should determine whether there are company-level controls in place. If so, the auditor should evaluate the documentation and test such company-level controls. If not, the auditor should perform tests of controls at some of the locations or business units.

B3. No further work is necessary on the remaining locations or businesses, provided that they are not able to create, either individually or in the aggregate, a material misstatement in the financial statements.

Locations or Business Units That Are Financially Significant

B4. Because of the importance of financially significant locations or business units, the auditor should evaluate management's documentation of and perform tests of controls over all relevant assertions related to significant accounts and disclosures at each financially significant location or business unit, as discussed in paragraphs 83 through 105. Generally, a relatively small number of locations or business units will encompass a large portion of a company's operations and financial position, making them financially significant.

B5. In determining the nature, timing, and extent of testing at the individual locations or business units, the auditor should evaluate each entity's involvement, if any, with a central processing or shared service environment.

Locations or Business Units That Involve Specific Risks

B6. Although a location or business unit might not be individually financially significant, it might present specific risks that, by themselves, could create a material misstatement in the company's financial statements. The auditor should test the controls over the specific risks that could create a material misstatement in the company's financial statements. The auditor need not test controls over all relevant assertions related to all significant accounts at these locations or business units. For example, a business unit responsible for foreign exchange trading could expose the company to the risk of material misstatement, even though the relative financial significance of such transactions is low.

Locations or Business Units That Are Significant Only When Aggregated with Other Locations and Business Units

B7. In determining the nature, timing, and extent of testing, the auditor should determine whether management has documented and placed in operation company-level controls (See paragraph 53) over individually unimportant locations and business units that, when aggregated with other locations or business units, might have a high level of financial significance. A high level of financial significance could create a greater than remote risk of material misstatement of the financial statements.

B8. For the purposes of this evaluation, company-level controls are controls management has in place to provide assurance that appropriate controls exist throughout the organization, including at individual locations or business units.

B9. The auditor should perform tests of company-level controls to determine whether such controls are operating effectively. The auditor might conclude that he or she cannot evaluate the operating effectiveness of such controls without visiting some or all of the locations or business units.

B10. If management does not have company-level controls operating at these locations and business units, the auditor should determine the nature, timing, and extent of procedures to be performed at each location, business unit, or combination of locations and business units. When determining the locations or business units to visit and the controls to test, the auditor should evaluate the following factors:

- The relative financial significance of each location or business unit.
- The risk of material misstatement arising from each location or business unit.
- The similarity of business operations and internal control over financial reporting at the various locations or business units.
- The degree of centralization of processes and financial reporting applications.
- The effectiveness of the control environment, particularly management's direct control over the exercise of authority delegated to others and its ability to effectively supervise activities at the various locations or business units. An ineffective control environment over the locations or business units might constitute a material weakness.
- The nature and amount of transactions executed and related assets at the various locations or business units.
- The potential for material unrecognized obligations to exist at a location or business unit and the degree to which the location or business unit could create an obligation on the part of the company.
- Management's risk assessment process and analysis for excluding a location or business unit from its assessment of internal control over financial reporting.

B11. Testing company-level controls is not a substitute for the auditor's testing of controls over a large portion of the company's operations or financial position. If the auditor cannot test a large portion of the company's operations and financial position by selecting a relatively small number of locations or business units, he or she should expand the number of locations or business units selected to evaluate internal control over financial reporting.

> Note: The evaluation of whether controls over a large portion of the company's operations or financial position have been tested should be made at the overall level, not at the individual significant account level.

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Locations and Business Units That Do Not Require Testing

B12. No testing is required for locations or business units that individually, and when aggregated with others, could not result in a material misstatement to the financial statements.

Multi-Location Testing Considerations Flowchart

B13. Illustration B-1 depicts how to apply the directions in this section to a hypothetical company with 150 locations or business units, along with the auditor's testing considerations for those locations or business units.

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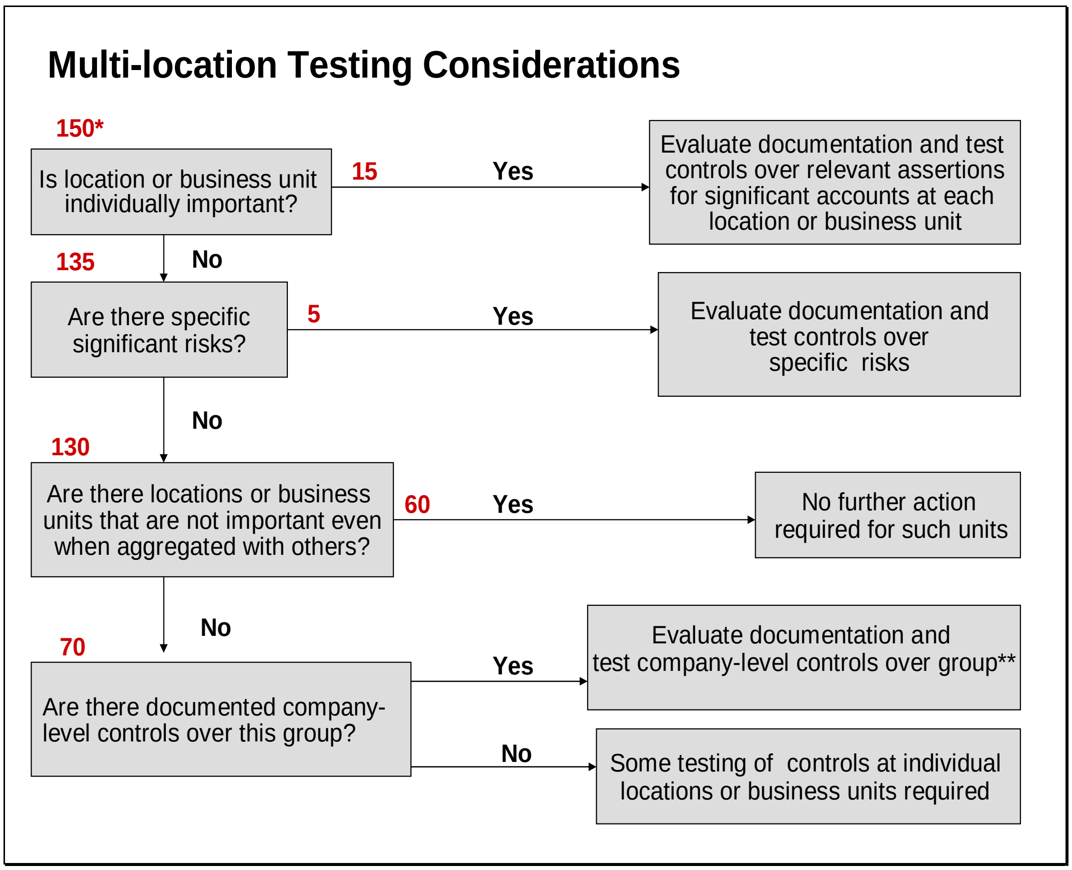
Illustration B-1



* Numbers represent number of locations affected.
** See paragraph B7.

Special Situations

B14. The scope of the evaluation of the company's internal control over financial reporting should include entities that are acquired on or before the date of management's assessment and operations that are accounted for as discontinued operations on the date of management's assessment. The auditor should consider this multiple locations discussion in determining whether it will be necessary to test controls at these entities or operations.

B15. For equity method investments, the evaluation of the company's internal control over financial reporting should include controls over the reporting in accordance with generally accepted accounting principles, in the company's financial statements, of the company's portion of the investees' income or loss, the investment balance, adjustments to the income or loss and investment balance, and related disclosures. The evaluation ordinarily would not extend to controls at the equity method investee.

B16. In situations in which the SEC allows management to limit its assessment of internal control over financial reporting by excluding certain entities, the auditor may limit the audit in the same manner and report without reference to the limitation in scope. However, the auditor should evaluate the reasonableness of management's conclusion that the situation meets the criteria of the SEC's allowed exclusion and the appropriateness of any required disclosure related to such a limitation. If the auditor believes that management's disclosure about the limitation requires modification, the auditor should follow the same communication responsibilities as described in paragraphs 204 and 205. If management and the audit committee do not respond appropriately, in addition to fulfilling those responsibilities, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons why the auditor believes management's disclosure should be modified.

B17. For example, for entities that are consolidated or proportionately consolidated, the evaluation of the company's internal control over financial reporting should include controls over significant accounts and processes that exist at the consolidated or proportionately consolidated entity. In some instances, however, such as for some variable interest entities as defined in Financial Accounting Standards Board Interpretation No. 46, *Consolidation of Variable Interest Entities,* management might not be able to obtain the information necessary to make an assessment because it does not have the ability to control the entity. If management is allowed to limit its assessment by excluding such entities,[1/] the auditor may limit the audit in the same manner and report

[1/] It is our understanding that the SEC Staff may conclude that management can limit the scope of its assessment if it does not have the authority to affect, and therefore cannot assess, the controls in place over certain amounts. This would relate to entities that are consolidated or proportionately consolidated when the issuer does not have sufficient control over the entity to assess and affect controls. If management's report on its assessment of the effectiveness of internal control over financial reporting is limited in that manner, the SEC staff may permit the company to without reference to the limitation in scope. In this case, the evaluation of the company's internal control over financial reporting should include evaluation of controls over the reporting in accordance with generally accepted accounting principles, in the company's financial statements, of the company's portion of the entity's income or loss, the investment balance, adjustments to the income or loss and investment balances, and related disclosures. However, the auditor should evaluate the reasonableness of management's conclusion that it does not have the ability to obtain the necessary information as well as the appropriateness of any required disclosure related to such a limitation.

Use of Service Organizations

B18. AU sec. 324, *Service Organizations,* applies to the audit of financial statements of a company that obtains services from another organization that are part of its information system. The auditor may apply the relevant concepts described in AU sec. 324 to the audit of internal control over financial reporting. Further, although AU sec. 324 was designed to address auditor-to-auditor communications as part of the audit of financial statements, it also is appropriate for management to apply the relevant concepts described in that standard to its assessment of internal control over financial reporting.

B19. Paragraph .03 of AU sec. 324 describes the situation in which a service organization's services are part of a company's information system. If the service organization's services are part of a company's information system, as described therein, then they are part of the information and communication component of the company's internal control over financial reporting. When the service organization's services are part of the company's internal control over financial reporting, management should consider the activities of the service organization in making its assessment of internal control over financial reporting, and the auditor should consider the activities of the service organization in determining the evidence required to support his or her opinion.

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disclose this fact as well as information about the magnitude of the amounts included in the financial statements from entities whose controls cannot be assessed. This disclosure would be required in each filing, but outside of management's report on its assessment of the effectiveness of internal control over financial reporting.

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Note: The use of a service organization does not reduce management's responsibility to maintain effective internal control over financial reporting.

B20. Paragraphs .07 through .16 in AU sec. 324 describe the procedures that management and the auditor should perform with respect to the activities performed by the service organization. The procedures include:

a. Obtaining an understanding of the controls at the service organization that are relevant to the entity's internal control and the controls at the user organization over the activities of the service organization, and

b. Obtaining evidence that the controls that are relevant to management's assessment and the auditor's opinion are operating effectively.

B21. Evidence that the controls that are relevant to management's assessment and the auditor's opinion are operating effectively may be obtained by following the procedures described in paragraph .12 of AU sec. 324. These procedures include:

a. Performing tests of the user organization's controls over the activities of the service organization (for example, testing the user organization's independent reperformance of selected items processed by the service organization or testing the user organization's reconciliation of output reports with source documents).

b. Performing tests of controls at the service organization.

c. Obtaining a service auditor's report on controls placed in operation and tests of operating effectiveness, or a report on the application of agreed-upon procedures that describes relevant tests of controls.

Note: The service auditor's report referred to above means a report with the service auditor's opinion on the service organization's description of the design of its controls, the tests of controls, and results of those tests performed by the service auditor, and the service auditor's opinion on whether the controls tested were operating effectively during the specified period (in other words, "reports on controls placed in operation and tests of operating effectiveness" described in paragraph .24b of AU sec. 324). A service auditor's report that does not include tests of controls, results of the tests, and the service auditor's opinion on operating effectiveness (in other words, "reports on controls placed in operation" described in paragraph .24a of AU sec. 324) does not provide evidence of operating effectiveness. Furthermore, if the evidence regarding operating effectiveness of controls comes from an agreed-upon procedures report rather than a service auditor's report issued pursuant to AU sec. 324, management and the auditor should evaluate whether the agreed-upon procedures report provides sufficient evidence in the same manner described in the following paragraph.

B22. If a service auditor's report on controls placed in operation and tests of operating effectiveness is available, management and the auditor may evaluate whether this report provides sufficient evidence to support the assessment and opinion, respectively. In evaluating whether such a service auditor's report provides sufficient evidence, management and the auditor should consider the following factors:

- The time period covered by the tests of controls and its relation to the date of management's assessment,
- The scope of the examination and applications covered, the controls tested, and the way in which tested controls relate to the company's controls,
- The results of those tests of controls and the service auditor's opinion on the operating effectiveness of the controls.

Note: These factors are similar to factors the auditor would consider in determining whether the report provides sufficient evidence to support the auditor's assessed level of control risk in an audit of the financial statements as described in paragraph .16 of AU sec. 324.

B23. If the service auditor's report on controls placed in operation and tests of operating effectiveness contains a qualification that the stated control objectives might be achieved only if the company applies controls contemplated in the design of the system by the service organization, the auditor should evaluate whether the company is applying the necessary procedures. For example, completeness of processing payroll transactions might depend on the company's validation that all payroll records sent to the service organization were processed by checking a control total.

B24. In determining whether the service auditor's report provides sufficient evidence to support management's assessment and the auditor's opinion, management and the auditor should make inquiries concerning the service auditor's reputation, competence, and independence. Appropriate sources of information concerning the professional reputation of the service auditor are discussed in paragraph .10a of AU sec. 543, *Part of Audit Performed by Other Independent Auditors.*

B25. When a significant period of time has elapsed between the time period covered by the tests of controls in the service auditor's report and the date of management's assessment, additional procedures should be performed. The auditor should inquire of management to determine whether management has identified any changes in the service organization's controls subsequent to the period covered by the service auditor's report (such as changes communicated to management from the service organization, changes in personnel at the service organization with whom management interacts, changes in reports or other data received from the service organization, changes in contracts or service level agreements with the service organization, or errors identified in the service organization's processing). If management has identified such changes, the auditor should determine whether management has performed procedures to evaluate the effect of such changes on the effectiveness of the company's internal control over financial reporting. The auditor also should consider whether the results of other procedures he or she performed indicate that there have been changes in the controls at the service organization that management has not identified.

B26. The auditor should determine whether to obtain additional evidence about the operating effectiveness of controls at the service organization based on the procedures performed by management or the auditor and the results of those procedures and on an evaluation of the following factors. As these factors increase in significance, the need for the auditor to obtain additional evidence increases.

- The elapsed time between the time period covered by the tests of controls in the service auditor's report and the date of management's assessment,
- The significance of the activities of the service organization,
- Whether there are errors that have been identified in the service organization's processing, and
- The nature and significance of any changes in the service organization's controls identified by management or the auditor.

B27. If the auditor concludes that additional evidence about the operating effectiveness of controls at the service organization is required, the auditor's additional procedures may include:

- Evaluating the procedures performed by management and the results of those procedures.
- Contacting the service organization, through the user organization, to obtain specific information.
- Requesting that a service auditor be engaged to perform procedures that will supply the necessary information.
- Visiting the service organization and performing such procedures.

B28. Based on the evidence obtained, management and the auditor should determine whether they have obtained sufficient evidence to obtain the reasonable assurance necessary for their assessment and opinion, respectively.

B29. The auditor should not refer to the service auditor's report when expressing an opinion on internal control over financial reporting.

Examples of Extent-of-Testing Decisions

B30. As discussed throughout this standard, determining the effectiveness of a company's internal control over financial reporting includes evaluating the design and operating effectiveness of controls over all relevant assertions related to all significant accounts and disclosures in the financial statements. Paragraphs 88 through 107 provide the auditor with directions about the nature, timing, and extent of testing of the design and operating effectiveness of internal control over financial reporting.

B31. Examples B-1 through B-4 illustrate how to apply this information in various situations. These examples are for illustrative purposes only.

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Example B-1 – ***Daily Programmed Application Control and Daily Information Technology-Dependent Manual Control***

The auditor has determined that cash and accounts receivable are significant accounts to the audit of XYZ Company's internal control over financial reporting. Based on discussions with company personnel and review of company documentation, the auditor learned that the company had the following procedures in place to account for cash received in the lockbox:

a. The company receives a download of cash receipts from the banks.

b. The information technology system applies cash received in the lockbox to individual customer accounts.

c. Any cash received in the lockbox and not applied to a customer's account is listed on an exception report (Unapplied Cash Exception Report).

   - Therefore, the application of cash to a customer's account is a programmed application control, while the review and follow-up of unapplied cash from the exception report is a manual control.

To determine whether misstatements in cash (existence assertion) and accounts receivable (existence, valuation, and completeness) would be prevented or detected on a timely basis, the auditor decided to test the controls provided by the system in the daily reconciliation of lock box receipts to customer accounts, as well as the control over reviewing and resolving unapplied cash in the Unapplied Cash Exception Report.

Nature, Timing, and Extent of Procedures. To test the programmed application control, the auditor:

- Identified, through discussion with company personnel, the software used to receive the download from the banks and to process the transactions and determined that the banks supply the download software.

  -- The company uses accounting software acquired from a third-party supplier. The software consists of a number of modules. The client modifies the software only for upgrades supplied by the supplier.

- Determined, through further discussion with company personnel, that the cash module operates the lockbox functionality and the posting of cash to the general ledger. The accounts receivable module posts the cash to individual customer accounts and produces the Unapplied Cash Exception Report, a standard report supplied with the package. The auditor agreed this information to the supplier's documentation.

- Identified, through discussions with company personnel and review of the supplier's documentation, the names, file sizes (in bytes), and locations of the executable files (programs) that operate the functionality under review. The auditor then identified the compilation dates of these programs and agreed them to the original installation date of the application.

- Identified the objectives of the programs to be tested. The auditor wanted to determine whether only appropriate cash items are posted to customers' accounts and matched to customer number, invoice number, amount, etc., and that there is a listing of inappropriate cash items (that is, any of the above items not matching) on the exception report.

In addition, the auditor had evaluated and tested general computer controls, including program changes (for example, confirmation that no unauthorized changes are undertaken) and logical access (for example, data file access to the file downloaded from the banks and user access to the cash and accounts receivable modules) and concluded that they were operating effectively.

To determine whether such programmed controls were operating effectively, the auditor performed a walkthrough in the month of July. The computer controls operate in a systematic manner, therefore, the auditor concluded that it was sufficient to perform a walkthrough for only the one item. During the walkthrough, the auditor performed and documented the following items:

a. Selected one customer and agreed the amount billed to the customer to the cash received in the lockbox.

b. Agreed the total of the lockbox report to the posting of cash receipts in the general ledger.

c. Agreed the total of the cash receipt download from the bank to the lockbox report and supporting documentation.

d. Selected one customer's remittance and agreed amount posted to the customer's account in the accounts receivable subsidiary ledger.

To test the detective control of review and follow up on the Daily Unapplied Cash Exception Report, the auditor:

a. Made inquiries of company personnel. To understand the procedures in place to ensure that all unapplied items are resolved, the time frame in which such resolution takes place, and whether unapplied items are handled properly within the system, the auditor discussed these matters with the employee responsible for reviewing and resolving the Daily Unapplied Cash Exception Reports. The auditor learned that, when items appear on the Daily-Unapplied Cash Exception Report, the employee must manually enter the correction into the system. The employee typically performs the resolution procedures the next business day. Items that typically appear on the Daily Unapplied Cash Exception Report relate to payments made by a customer without reference to an invoice number/purchase order number or to underpayments of an invoice due to quantity or pricing discrepancies.

b. Observed personnel performing the control**.** The auditor then observed the employee reviewing and resolving a Daily Unapplied Cash Exception Report. The day selected contained four exceptions – three related to payments made by a customer without an invoice number, and one related to an underpayment due to a pricing discrepancy.

- For the pricing discrepancy, the employee determined, through discussions with a sales person, that the customer had been billed an incorrect price; a price break that the sales person had granted to the customer was not reflected on the customer's invoice. The employee resolved the pricing discrepancy, determined which invoices were being paid, and entered a correction into the system to properly apply cash to the customer's account and reduce accounts receivable and sales accounts for the amount of the price break.

c. Reperformed the control. Finally, the auditor selected 25 Daily Unapplied Cash Exception Reports from the period January to September. For the reports selected, the auditor reperformed the follow-up procedures that the employee performed. For instance, the auditor inspected the documents and sources of information used in the follow-up and determined that the transaction was properly corrected in the system. The auditor also scanned other Daily Unapplied Cash Exception Reports to determine that the control was performed throughout the period of intended reliance.

Because the tests of controls were performed at an interim date, the auditor had to determine whether there were any significant changes in the controls from interim to year-end. Therefore, the auditor asked company personnel about the procedures in place at year-end. Such procedures had not changed from the interim period, therefore, the auditor observed that the controls were still in place by scanning Daily Unapplied Cash Exception Reports to determine the control was performed on a timely basis during the period from September to year-end.

Based on the auditor's procedures, the auditor concluded that the employee was clearing exceptions in a timely manner and that the control was operating effectively as of year-end.

Example B-2 – ***Monthly Manual Reconciliation***

The auditor determined that accounts receivable is a significant account to the audit of XYZ Company's internal control over financial reporting. Through discussions with company personnel and review of company documentation, the auditor learned that company personnel reconcile the accounts receivable subsidiary ledger to the general ledger on a monthly basis. To determine whether misstatements in accounts receivable (existence, valuation, and completeness) would be detected on a timely basis, the auditor decided to test the control provided by the monthly reconciliation process.

Nature, Timing, and Extent of Procedures. The auditor tested the company's reconciliation control by selecting a sample of reconciliations based upon the number of accounts, the dollar value of the accounts, and the volume of transactions affecting the account. Because the auditor considered all other receivable accounts immaterial, and because such accounts had only minimal transactions flowing through them, the auditor decided to test only the reconciliation for the trade accounts receivable account. The auditor elected to perform the tests of controls over the reconciliation process in conjunction with the auditor's substantive procedures over the accounts receivable confirmation procedures, which were performed in July.

To test the reconciliation process, the auditor:

a. Made inquiries of personnel performing the control. The auditor asked the employee performing the reconciliation a number of questions, including the following:

- What documentation describes the account reconciliation process?
- How long have you been performing the reconciliation work?
- What is the reconciliation process for resolving reconciling items?
- How often are the reconciliations formally reviewed and signed off?
- If significant issues or reconciliation problems are noticed, to whose attention do you bring them?
- On average, how many reconciling items are there?
- How are old reconciling items treated?
- If need be, how is the system corrected for reconciling items?
- What is the general nature of these reconciling items?

b. Observed the employee performing the control. The auditor observed the employee performing the reconciliation procedures. For nonrecurring reconciling items, the auditor observed whether each item included a clear explanation as to its nature, the action that had been taken to resolve it, and whether it had been resolved on a timely basis.

c. Reperformed the control. Finally, the auditor inspected the reconciliations and reperfomed the reconciliation procedures. For the May and July reconciliations, the auditor traced the reconciling amounts to the source documents on a test basis. The only reconciling item that appeared on these reconciliations was cash received in the lockbox the previous day that had not been applied yet to the customer's account. The auditor pursued the items in each month's reconciliation to determine that the reconciling item cleared the following business day. The auditor also scanned through the file of all reconciliations prepared during the year and noted that they had been performed on a timely basis. To determine that the company had not made significant changes in its reconciliation control procedures from interim to year-end, the auditor made inquiries of company personnel and determined that such procedures had not changed from interim to year-end. Therefore, the auditor verified that controls were still in place by scanning the monthly account reconciliations to determine that the control was performed on a timely basis during the interim to year-end period.

Based on the auditor's procedures, the auditor concluded that the reconciliation control was operating effectively as of year-end.

Example B-3 – ***Daily Manual Preventive Control***

The auditor determined that cash and accounts payable were significant accounts to the audit of the company's internal control over financial reporting. Through discussions with company personnel, the auditor learned that company personnel make a cash disbursement only after they have matched the vendor invoice to the receiver and purchase order. To determine whether misstatements in cash (existence) and accounts payable (existence, valuation, and completeness) would be prevented on a timely basis, the auditor tested the control over making a cash disbursement only after matching the invoice with the receiver and purchase.

Nature, Timing, and Extent of Procedures. On a haphazard basis, the auditor selected 25 disbursements from the cash disbursement registers from January through September. In this example, the auditor deemed a test of 25 cash disbursement transactions an appropriate sample size because the auditor was testing a manual control performed as part of the routine processing of cash disbursement transactions through the system. Furthermore, the auditor expected no errors based on the results of company-level tests performed earlier. [If, however, the auditor had encountered a control exception, the auditor would have attempted to identify the root cause of the exception and tested an additional number of items. If another control exception had been noted, the auditor would have decided that this control was not effective. As a result, the auditor would have decided to increase the extent of substantive procedures to be performed in connection with the financial statement audit of the cash and accounts payable accounts.]

a. After obtaining the related voucher package, the auditor examined the invoice to see if it included the signature or initials of the accounts payable clerk, evidencing the clerk's performance of the matching control. However, a signature on a voucher package to indicate signor approval does not necessarily mean that the person carefully reviewed it before signing. The voucher package may have been signed based on only a cursory review, or without any review.

b. The auditor decided that the quality of the evidence regarding the effective operation of the control evidenced by a signature or initials was not sufficiently persuasive to ensure that the control operated effectively during the test period. In order to obtain additional evidence, the auditor reperformed the matching control corresponding to the signature, which included examining the invoice to determine that (a) its items matched to the receiver and purchase order and (b) it was mathematically accurate.

Because the auditor performed the tests of controls at an interim date, the auditor updated the testing through the end of the year (initial tests are through September to December) by asking the accounts payable clerk whether the control was still in place and operating effectively. The auditor confirmed that understanding by performing a walkthrough of one transaction in December.

Based on the auditor's procedures, the auditor concluded that the control over making a cash disbursement only after matching the invoice with the receiver and purchase was operating effectively as of year-end.

Example B-4 – ***Programmed Prevent Control and Weekly Information Technology-Dependent Manual Detective Control***

The auditor determined that cash, accounts payable, and inventory were significant accounts to the audit of the company's internal control over financial reporting. Through discussions with company personnel, the auditor learned that the company's computer system performs a three-way match of the receiver, purchase order, and invoice. If there are any exceptions, the system produces a list of unmatched items that employees review and follow up on weekly.

In this case, the computer match is a programmed application control, and the review and follow-up of the unmatched items report is a detective control. To determine whether misstatements in cash (existence) and accounts payable/inventory (existence, valuation, and completeness) would be prevented or detected on a timely basis, the auditor decided to test the programmed application control of matching the receiver, purchase order, and invoice as well as the review and follow-up control over unmatched items.

Nature, Timing, and Extent of Procedures. To test the programmed application control, the auditor:

a. Identified, through discussion with company personnel, the software used to process receipts and purchase invoices. The software used was a third-party package consisting of a number of modules.

b. Determined, through further discussion with company personnel, that they do not modify the core functionality of the software, but sometimes make personalized changes to reports to meet the changing needs of the business. From previous experience with the company's information technology environment, the auditor believes that such changes are infrequent and that information technology process controls are well established.

c. Established, through further discussion, that the inventory module operated the receiving functionality, including the matching of receipts to open purchase orders. Purchase invoices were processed in the accounts payable module, which matched them to an approved purchase order against which a valid receipt has been made. That module also produced the Unmatched Items Report, a standard report supplied with the package to which the company has not made any modifications. That information was agreed to the supplier's documentation and to documentation within the information technology department.

d. Identified, through discussions with the client and review of the supplier's documentation, the names, file sizes (in bytes), and locations of the executable files (programs) that operate the functionality under review. The auditor then identified the compilation dates of the programs and agreed them to the original installation date of the application. The compilation date of the report code was agreed to documentation held within the information technology department relating to the last change made to that report (a change in formatting).

e. Identified the objectives of the programs to be tested. The auditor wanted to determine whether appropriate items are received (for example, match a valid purchase order), appropriate purchase invoices are posted (for example, match a valid receipt and purchase order, non-duplicate reference numbers) and unmatched items (for example, receipts, orders or invoices) are listed on the exception report. The auditor then reperformed all those variations in the packages on a test-of-one basis to determine that the programs operated as described.

In addition, the auditor had evaluated and tested general computer controls, including program changes (for example, confirmation that no unauthorized changes are undertaken to the functionality and that changes to reports are appropriately authorized, tested, and approved before being applied) and logical access (for example, user access to the inventory and accounts payable modules and access to the area on the system where report code is maintained), and concluded that they were operating effectively. (Since the computer is deemed to operate in a systematic manner, the auditor concluded that it was sufficient to perform a walkthrough for only the one item.)

To determine whether the programmed control was operating effectively, the auditor performed a walkthrough in the month of July. As a result of the walkthrough, the auditor performed and documented the following items:

a. Receiving cannot record the receipt of goods without matching the receipt to a purchase order on the system. The auditor tested that control by attempting to record the receipt of goods into the system without a purchase order. However, the system did not allow the auditor to do that. Rather, the system produced an error message stating that the goods could not be recorded as received without an active purchase order.

b. An invoice will not be paid unless the system can match the receipt and vendor invoice to an approved purchase order. The auditor tested that control by attempting to approve an invoice for payment in the system. The system did not allow the auditor to do that. Rather, it produced an error message indicating that invoices could not be paid without an active purchase order and receiver.

c. The system disallows the processing of invoices with identical vendor and identical invoice numbers. In addition, the system will not allow two invoices to be processed against the same purchase order unless the sum of the invoices is less than the amount approved on the purchase order. The auditor tested that control by attempting to process duplicate invoices. However, the system produced an error message indicating that the invoice had already been processed.

d. The system compares the invoice amounts to the purchase order. If there are differences in quantity/extended price, and such differences fall outside a pre-approved tolerance, the system does not allow the invoice to be processed. The auditor tested that control by attempting to process an invoice that had quantity/price differences outside the tolerance level of 10 pieces, or $1,000. The system produced an error message indicating that the invoice could not be processed because of such differences.

e. The system processes payments only for vendors established in the vendor master file. The auditor tested that control by attempting to process an invoice for a vendor that was not established in the vendor master file. However, the system did not allow the payment to be processed.

f. The auditor tested user access to the vendor file and whether such users can make modifications to such file by attempting to access and make changes to the vendor tables. However, the system did not allow the auditor to perform that function and produced an error message stating that the user was not authorized to perform that function.

g. The auditor verified the completeness and accuracy of the Unmatched Items Report by verifying that one unmatched item was on the report and one matched item was not on the report.

   Note: It is inadvisable for the auditor to have uncontrolled access to the company's systems in his or her attempts described above to record the receipt of goods without a purchase order, approve an invoice for payment, process duplicate invoices, etc. These procedures ordinarily are performed in the presence of appropriate company personnel so that they can be notified immediately of any breach to their systems.

To test the detect control of review and follow up on the Unmatched Items Report, the auditor performed the following procedures in the month of July for the period January to July:

a. Made inquiries of company personnel. To gain an understanding of the procedures in place to ensure that all unmatched items are followed-up properly and that corrections are made on a timely basis, the auditor made inquiries of the employee who follows up on the weekly-unmatched items reports. On a weekly basis, the control required the employee to review the Unmatched Items Report to determine why items appear on it. The employee's review includes proper follow-up on items, including determining whether:

- All open purchase orders are either closed or voided within an acceptable amount of time.
- The requesting party is notified periodically of the status of the purchase order and the reason for its current status.
- The reason the purchase order remains open is due to incomplete shipment of goods and, if so, whether the vendor has been notified.
- There are quantity problems that should be discussed with purchasing.

b. Observed the performance of the control**.** The auditor observed the employee performing the control for the Unmatched Items Reports generated during the first week in July.

c. Reperformed the control**.** The auditor selected five weekly Unmatched Items Reports, selected several items from each, and reperformed the procedures that the employee performed. The auditor also scanned other Unmatched Items Reports to determine that the control was performed throughout the period of intended reliance.

To determine that the company had not made significant changes in their controls from interim to year-end, the auditor discussed with company personnel the procedures in place for making such changes. Since the procedures had not changed from interim to year-end, the auditor observed that the controls were still in place by scanning the weekly Unmatched Items Reports to determine that the control was performed on a timely basis during the interim to year-end period.

Based on the auditor's procedures, the auditor concluded that the employee was clearing exceptions in a timely manner and that the control was operating effectively as of year-end.

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APPENDIX C

Safeguarding of Assets

C1. *Safeguarding of assets* is defined in paragraph 7 as those policies and procedures that "provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements." This definition is consistent with the definition provided in the Committee of Sponsoring Organizations (COSO) of the Treadway Commission's Addendum, *Reporting to External Parties*, which provides the following definition of internal control over safeguarding of assets:

> Internal control over safeguarding of assets against unauthorized acquisition, use or disposition is a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements. Such internal control can be judged effective if the board of directors and management have reasonable assurance that unauthorized acquisition, use or disposition of the entity's assets that could have a material effect on the financial statements is being prevented or detected on a timely basis.

C2. For example, a company has safeguarding controls over inventory tags (preventive controls) and also performs periodic physical inventory counts (detective control) timely in relation to its quarterly and annual financial reporting dates. Although the physical inventory count does not safeguard the inventory from theft or loss, it prevents a material misstatement to the financial statements if performed effectively and timely.

C3. Therefore, given that the definitions of material weakness and significant deficiency relate to the likelihood of misstatement of the financial statements, the failure of a preventive control such as inventory tags will not result in a significant deficiency or material weakness if the detective control (physical inventory) prevents a misstatement of the financial statements. The COSO Addendum also indicates that to the extent that such losses might occur, controls over financial reporting are effective if they provide

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reasonable assurance that those losses are properly reflected in the financial statements, thereby alerting financial statement users to consider the need for action.

> Note: *Properly reflected* in the financial statements includes both correctly recording the loss and adequately disclosing the loss.

C4. Material weaknesses relating to controls over the safeguarding of assets would only exist when the company does not have effective controls (considering both safeguarding and other controls) to prevent or detect a material misstatement of the financial statements.

C5. Furthermore, management's plans that could potentially affect financial reporting in future periods are not controls. For example, a company's business continuity or contingency planning has no effect on the company's current abilities to initiate, authorize, record, process, or report financial data. Therefore, a company's business continuity or contingency planning is not part of internal control over financial reporting.

C6. The COSO Addendum provides further information about safeguarding of assets as it relates to internal control over financial reporting.

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APPENDIX D

Examples of Significant Deficiencies and Material Weaknesses

D1. Paragraph 8 of this standard defines a control deficiency. Paragraphs 9 and 10 go on to define a significant deficiency and a material weakness, respectively.

D2. Paragraphs 22 through 23 of this standard discuss materiality in an audit of internal control over financial reporting, and paragraphs 130 through 140 provide additional direction on evaluating deficiencies in internal control over financial reporting.

D3. The following examples illustrate how to evaluate the significance of internal control deficiencies in various situations. These examples are for illustrative purposes only.

Example D-1**—** ***Reconciliations of Intercompany Accounts Are Not Performed on a Timely Basis***

Scenario A – Significant Deficiency. The company processes a significant number of routine intercompany transactions on a monthly basis. Individual intercompany transactions are not material and primarily relate to balance sheet activity, for example, cash transfers between business units to finance normal operations.

A formal management policy requires monthly reconciliation of intercompany accounts and confirmation of balances between business units. However, there is not a process in place to ensure performance of these procedures. As a result, detailed reconciliations of intercompany accounts are not performed on a timely basis. Management does perform monthly procedures to investigate selected large-dollar intercompany account differences. In addition, management prepares a detailed monthly variance analysis of operating expenses to assess their reasonableness.

Based only on these facts, the auditor should determine that this deficiency represents a significant deficiency for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be more than inconsequential, but less than material, because individual intercompany transactions are not material, and the compensating controls operating monthly should detect a material misstatement. Furthermore, the transactions are primarily restricted to balance sheet accounts. However, the compensating detective controls are designed only to detect material misstatements. The controls do not address the detection of misstatements that are more than inconsequential but less than material. Therefore, the likelihood that a misstatement that was more than inconsequential, but less than material, could occur is more than remote.

Scenario B - Material Weakness. The company processes a significant number of intercompany transactions on a monthly basis. Intercompany transactions relate to a wide range of activities, including transfers of inventory with intercompany profit between business units, allocation of research and development costs to business units and corporate charges. Individual intercompany transactions are frequently material.

A formal management policy requires monthly reconciliation of intercompany accounts and confirmation of balances between business units. However, there is not a process in place to ensure that these procedures are performed on a consistent basis. As a result, reconciliations of intercompany accounts are not performed on a timely basis, and differences in intercompany accounts are frequent and significant. Management does not perform any alternative controls to investigate significant intercompany account differences.

Based only on these facts, the auditor should determine that this deficiency represents a material weakness for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be material, because individual intercompany transactions are frequently material and relate to a wide range of activities. Additionally, actual unreconciled differences in intercompany accounts have been, and are, material. The likelihood of such a misstatement is more than remote because such misstatements have frequently occurred and compensating controls are not effective, either because they are not properly designed or not operating effectively. Taken together, the magnitude and likelihood of misstatement of the financial statements resulting from this internal control deficiency meet the definition of a material weakness.

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Example D-2—***Modifications to Standard Sales Contract Terms Not Reviewed To Evaluate Impact on Timing and Amount of Revenue Recognition***

Scenario A – Significant Deficiency. The company uses a standard sales contract for most transactions. Individual sales transactions are not material to the entity. Sales personnel are allowed to modify sales contract terms. The company's accounting function reviews significant or unusual modifications to the sales contract terms, but does not review changes in the standard shipping terms. The changes in the standard shipping terms could require a delay in the timing of revenue recognition. Management reviews gross margins on a monthly basis and investigates any significant or unusual relationships. In addition, management reviews the reasonableness of inventory levels at the end of each accounting period. The entity has experienced limited situations in which revenue has been inappropriately recorded in advance of shipment, but amounts have not been material.

Based only on these facts, the auditor should determine that this deficiency represents a significant deficiency for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be more than inconsequential, but less than material, because individual sales transactions are not material and the compensating detective controls operating monthly and at the end of each financial reporting period should reduce the likelihood of a material misstatement going undetected. Furthermore, the risk of material misstatement is limited to revenue recognition errors related to shipping terms as opposed to broader sources of error in revenue recognition. However, the compensating detective controls are only designed to detect material misstatements. The controls do not effectively address the detection of misstatements that are more than inconsequential but less than material, as evidenced by situations in which transactions that were not material were improperly recorded. Therefore, there is a more than remote likelihood that a misstatement that is more than inconsequential but less than material could occur.

Scenario B - Material Weakness. The company has a standard sales contract, but sales personnel frequently modify the terms of the contract. The nature of the modifications can affect the timing and amount of revenue recognized. Individual sales transactions are frequently material to the entity, and the gross margin can vary significantly for each transaction.

The company does not have procedures in place for the accounting function to regularly review modifications to sales contract terms. Although management reviews gross margins on a monthly basis, the significant differences in gross margins on individual transactions make it difficult for management to identify potential misstatements. Improper revenue recognition has occurred, and the amounts have been material.

Based only on these facts, the auditor should determine that this deficiency represents a material weakness for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be material, because individual sales transactions are frequently material, and gross margin can vary significantly with each transaction (which would make compensating detective controls based on a reasonableness review ineffective). Additionally, improper revenue recognition has occurred, and the amounts have been material. Therefore, the likelihood of material misstatements occurring is more than remote. Taken together, the magnitude and likelihood of misstatement of the financial statements resulting from this internal control deficiency meet the definition of a material weakness.

Scenario C – Material Weakness. The company has a standard sales contract, but sales personnel frequently modify the terms of the contract. Sales personnel frequently grant unauthorized and unrecorded sales discounts to customers without the knowledge of the accounting department. These amounts are deducted by customers in paying their invoices and are recorded as outstanding balances on the accounts receivable aging. Although these amounts are individually insignificant, they are material in the aggregate and have occurred consistently over the past few years.

Based on only these facts, the auditor should determine that this deficiency represents a material weakness for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be material, because the frequency of occurrence allows insignificant amounts to become material in the aggregate. The likelihood of material misstatement of the financial statements resulting from this internal control deficiency is more than remote (even assuming that the amounts were fully reserved for in the company's allowance for uncollectible accounts) due to the likelihood of material misstatement of the gross accounts receivable balance. Therefore, this internal control deficiency meets the definition of a material weakness.

Example D-3—***Identification of Several Deficiencies***

Scenario A – Material Weakness. During its assessment of internal control over financial reporting, management identified the following deficiencies. Based on the context in which the deficiencies occur, management and the auditor agree that these deficiencies individually represent significant deficiencies:

- Inadequate segregation of duties over certain information system access controls.
- Several instances of transactions that were not properly recorded in subsidiary ledgers; transactions were not material, either individually or in the aggregate.
- A lack of timely reconciliations of the account balances affected by the improperly recorded transactions.

Based only on these facts, the auditor should determine that the combination of these significant deficiencies represents a material weakness for the following reasons: Individually, these deficiencies were evaluated as representing a more than remote likelihood that a misstatement that is more than inconsequential, but less than material, could occur. However, each of these significant deficiencies affects the same set of accounts. Taken together, these significant deficiencies represent a more than remote likelihood that a material misstatement could occur and not be prevented or detected. Therefore, in combination, these significant deficiencies represent a material weakness.

Scenario B – Material Weakness. During its assessment of internal control over financial reporting, management of a financial institution identifies deficiencies in: the design of controls over the estimation of credit losses (a critical accounting estimate); the operating effectiveness of controls for initiating, processing, and reviewing adjustments to the allowance for credit losses; and the operating effectiveness of controls designed to prevent and detect the improper recognition of interest income. Management and the auditor agree that, in their overall context, each of these deficiencies individually represent a significant deficiency.

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In addition, during the past year, the company experienced a significant level of growth in the loan balances that were subjected to the controls governing credit loss estimation and revenue recognition, and further growth is expected in the upcoming year.

Based only on these facts, the auditor should determine that the combination of these significant deficiencies represents a material weakness for the following reasons:

- The balances of the loan accounts affected by these significant deficiencies have increased over the past year and are expected to increase in the future.
- This growth in loan balances, coupled with the combined effect of the significant deficiencies described, results in a more than remote likelihood that a material misstatement of the allowance for credit losses or interest income could occur.

Therefore, in combination, these deficiencies meet the definition of a material weakness.

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APPENDIX E

BACKGROUND AND BASIS FOR CONCLUSIONS

Table of Contents	*Paragraph*

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Introduction

E1. This appendix summarizes factors that the Public Company Accounting Oversight Board (the "Board") deemed significant in reaching the conclusions in the standard. This appendix includes reasons for accepting certain views and rejecting others.

Background

E2. Section 404(a) of the Sarbanes-Oxley Act of 2002 (the "Act"), and the Securities and Exchange Commission's (SEC) related implementing rules, require the management of a public company to assess the effectiveness of the company's internal control over financial reporting, as of the end of the company's most recent fiscal year. Section 404(a) of the Act also requires management to include in the company's annual report to shareholders management's conclusion as a result of that assessment of whether the company's internal control over financial reporting is effective.

E3. 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.

E4. The backdrop for the development of the Board's first major auditing standard was, of course, the spectacular audit failures and corporate malfeasance that led to the passage of the Act. Although all of the various components of the Act work together to help restore investor confidence and help prevent the types of financial reporting breakdowns that lead to the loss of investor confidence, Section 404 of the Act is certainly one of the most visible and tangible changes required by the Act.

E5. The Board believes that effective controls provide the foundation for reliable financial reporting. Congress believed this too, which is why the new reporting by management and the auditor on the effectiveness of internal control over financial reporting received such prominent attention in the Act. Internal control over financial reporting enhances a company's ability to produce fair and complete financial reports. Without reliable financial reports, making good judgments and decisions about a company becomes very difficult for anyone, including the board of directors, management, employees, investors, lenders, customers, and regulators. The auditor's reporting on management's assessment of the effectiveness of internal control over

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financial reporting provides users of that report with important assurance about the reliability of the company's financial reporting.

E6. The Board's efforts to develop this standard were an outward expression of the Board's mission, "to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports." As part of fulfilling that mission as it relates to this standard, the Board considered the advice that respected groups had offered to other auditing standards setters in the past. For example, the Public Oversight Board's Panel on Audit Effectiveness recommended that "auditing standards need to provide clear, concise and definitive imperatives for auditors to follow."[1/] As another example, the International Organization of Securities Commissioners advised the International Auditing and Assurance Standards Board "that the IAASB must take care to avoid language that could inadvertently encourage inappropriate shortcuts in audits, at a time when rigorous audits are needed more than ever to restore investor confidence."[2/]

E7. The Board understood that, to effectively fulfill its mission and for this standard to achieve its ultimate goal of restoring investor confidence by increasing the reliability of public company financial reporting, the Board's standard must contain clear directions to the auditor consistent with investor's expectations that the reliability of financial reporting be significantly improved. Just as important, the Board recognized that this standard must appropriately balance the costs to implement the standard's directions with the benefits of achieving these important goals. As a result, all of the Board's decisions about this standard were guided by the additional objective of creating a rational relationship between costs and benefits.

[1/] Panel on Audit Effectiveness, *Report and Recommendations,* sec. 2.228 (August 31, 2000).

[2/] April 8, 2003 comment letter from the International Organization of Securities Commissions to the International Auditing and Assurance Standards Board regarding the proposed international standards on audit risk (Amendment to ISA 200, "Objective and Principles Governing an Audit of Financial Statements;" proposed ISAs, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement;" "Auditor's Procedures in Response to Assessed Risks;" and "Audit Evidence").

E8. When the Board adopted its interim attestation standards in Rule 3300T on an initial, transitional basis, the Board adopted a pre-existing standard governing an auditor's attestation on internal control over financial reporting.[3/] As part of the Board's process of evaluating that pre-existing standard, the Board convened a public roundtable discussion on July 29, 2003 to discuss issues and hear views related to reporting on internal control over financial reporting. The participants at the roundtable included representatives from public companies, accounting firms, investor groups, and regulatory organizations. Based on comments made at the roundtable, advice from the Board's staff, and other input the Board received, the Board determined that the pre-existing standard governing an auditor's attestation on internal control over financial reporting was insufficient for effectively implementing the requirements of Section 404 of the Act and for the Board to appropriately discharge its standard-setting obligations under Section 103(a) of the Act. In response, the Board developed and issued, on October 7, 2003, a proposed auditing standard titled, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements.*

E9. The Board received 189 comment letters on a broad array of topics from a variety of commenters, including auditors, investors, internal auditors, issuers, regulators, and others. Those comments led to changes in the standard, intended to make the requirements of the standard clearer and more operational. This appendix summarizes significant views expressed in those comment letters and the Board's responses.

Fundamental Scope of the Auditor's Work in an Audit of Internal Control over Financial Reporting

E10. The proposed standard stated that the auditor's objective in an audit of internal control over financial reporting was to express an opinion on management's assessment of the effectiveness of the company's internal control over financial reporting. To render such an opinion, the proposed standard required the auditor to obtain reasonable assurance about whether the company maintained, in all material respects, effective internal control over financial reporting as of the date specified in

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[3/] The pre-existing standard is Chapter 5, "*Reporting on an Entity's Internal Control Over Financial Reporting*" of Statement on Standards for Attestation Engagements (SSAE) No. 10*, Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards,* Vol. 1, AT sec. 501). SSAE No. 10 has been codified into AICPA *Professional Standards*, Volume 1, as AT sections 101 through 701.

management's report. To obtain reasonable assurance, the auditor was required to evaluate both management's process for making its assessment and the effectiveness of internal control over financial reporting.

E11. Virtually all investors and auditors who submitted comment letters expressed support for this approach. Other commenters, primarily issuers, expressed concerns that this approach was contrary to the intent of Congress and, therefore, beyond what was specifically required by Section 404 of the Act. Further, issuers stated their views that this approach would lead to unnecessary and excessive costs. Some commenters in this group suggested the auditor's work should be limited to evaluating management's assessment process and the testing performed by management and internal audit. Others acknowledged that the auditor would need to test at least some controls directly in addition to evaluating and testing management's assessment process. However, these commenters described various ways in which the auditor's own testing could be significantly reduced from the scope expressed in the proposed standard. For instance, they proposed that the auditor could be permitted to use the work of management and others to a much greater degree; that the auditor could use a "risk analysis" to identify only a few controls to be tested; and a variety of other methods to curtail the extent of the auditor's work. Of those opposed to the scope, most cited their belief that the scope of work embodied in the standard would lead to a duplication of effort between management and the auditor which would needlessly increase costs without adding significant value.

E12. After considering the comments, the Board retained the approach described in the proposed standard. The Board concluded that the approach taken in the standard is consistent with the intent of Congress. Also, to provide the type of report, at the level of assurance called for in Sections 103 and 404, the Board concluded that the auditor must evaluate both management's assessment process and the effectiveness of internal control over financial reporting. Finally, the Board noted the majority of the cost to be borne by companies (and ultimately investors) results directly from the work the company will have to perform to maintain effective internal control over financial reporting and to comply with Section 404(a) of the Act. The cost of the auditor's work as described in this standard ultimately will represent a smaller portion of the total cost to companies of implementing Section 404.

E13. The Board noted that large, federally insured financial institutions have had a similar internal control reporting requirement for over ten years. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) has required, since 1993, managements of large financial institutions to make an assessment of internal control over financial reporting effectiveness and the institution's independent auditor to issue an attestation report on management's assessment.

E14. The attestation standards under which FDICIA engagements are currently performed are clear that, when performing an examination of management's assertion on the effectiveness of internal control over financial reporting (management's report on the assessment required by Section 404(a) of the Act must include a statement as to whether the company's internal control over financial reporting is effective), the auditor may express an opinion either on management's assertion (that is, whether management's assessment about the effectiveness of the internal control over financial reporting is fairly stated) or directly on the subject matter (that is, whether the internal control over financial reporting is effective) because the level of work that must be performed is the same in either case.

E15. The Board observed that Congress indicated an intent to require an examination level of work in Section 103(a) of the Act, which states, in part, that each registered public accounting firm shall:

> describe in each audit report the scope of the auditor's testing of the internal control structure and procedures of the issuer, required by Section 404(b), and present (in such report or in a separate report)—
>
> (I) the findings of the auditor from such testing;
>
> **(II) an evaluation of whether such internal control structure and procedures—**
>
> **(aa) include maintenance of records that in reasonable detail accurately reflect the transactions and dispositions of the assets of the issuer;**
>
> **(bb) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer**; and

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(III) a description, at a minimum, of material weaknesses in such internal controls, and of any material noncompliance found on the basis of such testing. [emphasis added].

E16. The Board concluded that the auditor must test internal control over financial reporting directly, in the manner and extent described in the standard, to make the evaluation described in Section 103. The Board also interpreted Section 103 to provide further support that the intent of Congress was to require an opinion on the effectiveness of internal control over financial reporting.

E17. The Board concluded that the auditor must obtain a high level of assurance that the conclusion expressed in management's assessment is correct to provide an opinion on management's assessment. An auditing process restricted to evaluating what management has done would not provide the auditor with a sufficiently high level of assurance that management's conclusion is correct. Instead, it is necessary for the auditor to evaluate management's assessment process to be satisfied that management has an appropriate basis for its statement, or assertion, about the effectiveness of the company's internal control over financial reporting. It also is necessary for the auditor to directly test the effectiveness of internal control over financial reporting to be satisfied that management's conclusion is correct, and that management's assertion is fairly stated.

E18. This testing takes on added importance with the public nature of the internal control reporting. Because of the auditor's association with a statement by management that internal control over financial reporting is effective, it is reasonable for a user of the auditor's report to expect that the auditor tested the effectiveness of internal control over financial reporting. For the auditor to do otherwise would create an expectation gap, in which the assurance that the auditor obtained is less than what users reasonably expect.

E19. Auditors, investors, and the Federal bank regulators reaffirmed in their comment letters on the proposed auditing standard that the fundamental approach taken by the Board was appropriate and necessary. Investors were explicit in their expectation that the auditor must test the effectiveness of controls directly in addition to evaluating management's assessment process. Investors further recognized that this kind of assurance would come at a price and expressed their belief that the cost of the anticipated benefits was reasonable. The federal banking regulators, based on their experience examining financial institutions' internal control assessments and

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independent auditors' attestation reports under FDICIA, commented that the proposed auditing standard was a significant improvement over the existing attestation standard.

Reference to Audit vs. Attestation

E20. The proposed standard referred to the attestation required by Section 404(b) of the Act as the *audit* of internal control over financial reporting instead of an *attestation* of management's assessment. The proposed standard took that approach both because the auditor's objective is to express an opinion on management's assessment of the effectiveness of internal control over financial reporting, just as the auditor's objective in an audit of the financial statements is to express an opinion on the fair presentation of the financial statements, and because the level of assurance obtained by the auditor is the same in both cases. Furthermore, the proposed standard described an *integrated* audit of the financial statements and internal control over financial reporting and allowed the auditor to express his or her opinions on the financial statements and on the effectiveness of internal control in separate reports or in a single, combined report.

E21. Commenters' views on this matter frequently were related to their views on whether the proposed scope of the audit was appropriate. Those who agreed that the scope in the proposed standard was appropriate generally agreed that referring to the engagement as an *audit* was appropriate. On the other hand, commenters who objected to the scope of work described in the proposed standard often drew an important distinction between an *audit* and an *attestation.* Because Section 404 calls for an *attestation*, they believed it was inappropriate to call the engagement anything else (or to mandate a scope that called for a more extensive level of work).

E22. Based, in part, on the Board's decisions about the scope of the audit of internal control over financial reporting, the Board concluded that the engagement should continue to be referred to as an "audit." This term emphasizes the nature of the auditor's objective and communicates that objective most clearly to report users. Use of this term also is consistent with the integrated approach described in the standard and the requirement in Section 404 of the Act that this reporting not be subject to a separate engagement.

E23. Because the Board's standard on internal control is an auditing standard, it is preferable to use the term *audit* to describe the engagement rather than the term *examination*, which is used in the attestation standards to describe an engagement designed to provide a high level of assurance.

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E24. Finally, the Board believes that using the term *audit* helps dispel the misconception that an audit of internal control over financial reporting is a different level of service than an attestation of management's assessment of internal control over financial reporting.

Form of the Auditor's Opinion

E25. The proposed auditing standard required that the auditor's opinion in his or her report state whether management's assessment of the effectiveness of the company's internal control over financial reporting as of the specified date is fairly stated, in all material respects, based on the control criteria. However, the proposed standard also stated that nothing precluded the auditor from auditing management's assessment and opining directly on the effectiveness of internal control over financial reporting. This is because the scope of the work, as defined by the proposed standard, was the same, regardless of whether the auditor reports on management's assessment or directly on the effectiveness of internal control over financial reporting. The form of the opinion was essentially interchangeable between the two.

E26. However, if the auditor planned to issue other than an unqualified opinion, the proposed standard required the auditor to report directly on the effectiveness of the company's internal control over financial reporting rather than on management's assessment. The Board initially concluded that expressing an opinion on management's assessment, in these circumstances, did not most effectively communicate the auditor's conclusion that internal control was not effective. For example, if management expresses an adverse assessment because a material weakness exists at the date of management's assessment ("…internal control over financial reporting is not effective…") and the auditor expresses his or her opinion on management's assessment ("…management's assessment that internal control over financial reporting is not effective is fairly stated, in all material respects…"), a reader might not be clear about the results of the auditor's testing and about the auditor's conclusions. The Board initially decided that reporting directly on the effectiveness of the company's internal control over financial reporting better communicates to report users the effect of such conditions, because direct reporting more clearly states the auditor's conclusions about the effectiveness of internal control over financial reporting ("In our opinion, because of the effect of the material weakness described…, the Company's internal control over financial reporting is not effective.").

E27. A number of commenters were supportive of the model described in the previous paragraph, as they agreed with the Board's reasoning. However, several commenters

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believed that report users would be confused as to why the form of the auditor's opinion would be different in various circumstances. These commenters thought that the auditor's opinion should be consistently expressed in all reports. Several auditors recommended that auditors always report directly on the effectiveness of the company's internal control over financial reporting. They reasoned that the scope of the audit—which always would require the auditor to obtain reasonable assurance about whether the internal control over financial reporting was effective—would be more clearly communicated, in all cases, by the auditor reporting directly on the effectiveness of internal control over financial reporting. Other commenters suggested that the auditor always should express two opinions: one on management's assessment and one directly on the effectiveness of internal control over financial reporting. They believed the Act called for two opinions: Section 404 calls for an opinion on management's assessment, while Section 103 calls for an opinion directly on the effectiveness of internal control over financial reporting.

E28. The Board believes that the reporting model in the proposed standard is appropriate. However, the Board concluded that the expression of two opinions—one on management's assessment and one on the effectiveness of internal control over financial reporting—in all reports is a superior approach that balances the concerns of many different interested parties. This approach is consistent with the scope of the audit, results in more consistent reporting in differing circumstances, and makes the reports more easily understood by report users. Therefore, the standard requires that the auditor express two opinions in all reports on internal control over financial reporting.

Use of the Work of Others

E29. After giving serious consideration to a rational relationship between costs and benefits, the Board decided to change the provisions in the proposed standard regarding using the work of others. The proposed standard required the auditor to evaluate whether to use the work of others, such as internal auditors and others working under the direction of management, and described an evaluation process focused on the competence and objectivity of the persons who performed the work that the auditor was required to use when determining the extent to which he or she could use the work of others.

E30. The proposed standard also described two principles that limited the auditor's ability to use of the work of others. First, the proposed standard defined three categories of controls and the extent to which the auditor could use the work of others in each of those categories:

- Controls for which the auditor should not rely on the work of others, such as controls in the control environment and controls specifically intended to prevent or detect fraud that is reasonably likely to have a material effect on the company's financial statements,

- Controls for which the auditor may rely on the work of others, but his or her reliance on the work of others should be limited, such as controls over nonroutine transactions that are considered high risk because they involve judgments and estimates, and

- Controls for which the auditor's reliance on the work of others is not specifically limited, such as controls over routine processing of significant accounts.

E31. Second, the proposed standard required that, on an overall basis, the auditor's own work must provide the principal evidence for the audit opinion (this is referred to as the *principal evidence provision*).

E32. In the proposed standard, these two principles provided the auditor with flexibility in using the work of others while preventing him or her from placing inappropriate over-reliance on the work of others. Although the proposed standard required the auditor to reperform some of the tests performed by others to use their work, it did not establish specific requirements for the extent of the reperformance. Rather, it allowed the auditor to use his or her judgment and the directions provided by the two principles discussed in the previous two paragraphs to determine the appropriate extent of reperformance.

E33. The Board received a number of comments that agreed with the proposed three categories of controls and the principal evidence provision. However, most commenters expressed some level of concern with the categories, the principal evidence provision, or both.

E34. Comments opposing or criticizing the categories of controls varied from general to very specific. In general terms, many commenters (particularly issuers) expressed concern that the categories described in the proposed standard were too restrictive. They believed the auditor should be able to use his or her judgment to determine in which areas and to what extent to rely on the work of others. Other commenters indicated that the proposed standard did not place enough emphasis on the work of internal auditors whose competence and objectivity, as well as adherence to professional standards of internal auditing, should clearly set their work apart from the work performed by others in the organization (such as management or third parties working under management's direction). Further, these commenters believed that the standard should clarify that the auditor should be able to use work performed by internal auditors extensively. In that case, their concerns about excessive cost also would be partially alleviated.

E35. Other commenters expressed their belief that the proposed standard repudiated the approach established in AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,* for the auditor's use of the work of internal auditors in a financial statement audit. Commenters also expressed very specific and pointed views on the three categories of controls. As defined in the proposed standard, the first category (in which the auditor should not use the work of others at all) included:

- Controls that are part of the control environment, including controls specifically established to prevent and detect fraud that is reasonably likely to result in material misstatement of the financial statements.

- Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; to initiate, record, and process journal entries in the general ledger; and to record recurring and nonrecurring adjustments to the financial statements (for example, consolidating adjustments, report combinations, and reclassifications).

- 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.

- Walkthroughs.

E36. Commenters expressed concern that the prohibition on using the work of others in these areas would (a) drive unnecessary and excessive costs, (b) not give appropriate recognition to those instances in which the auditor evaluated internal audit as having a high degree of competence and objectivity, and (c) be impractical due to resource constraints at audit firms. Although each individual area was mentioned, the

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strongest and most frequent objections were to the restrictions imposed over the inclusion in the first category of walkthroughs, controls over the period-end financial reporting process, and information technology general controls. Some commenters suggested the Board should consider moving these areas from the first category to the second category (in which using the work of others would be limited, rather than prohibited); others suggested removing any limitation on using the work of others in these areas altogether.

E37. Commenters also expressed other concerns with respect to the three control categories. Several commenters asked for clarification on what constituted *limited* use of the work of others for areas included in the second category. Some commenters asked for clarification about the extent of reperformance necessary for the auditor to use the work of others. Other commenters questioned the meaning of the term *without specific limitation* in the third category by asking, did this mean that the auditor could use the work of others in these areas without performing *or* reperforming *any* work in those areas?

E38. Although most commenters suggested that the principal evidence threshold for the auditor's own work be retained, some commenters objected to the principal evidence provision. Although many commenters identified the broad array of areas identified in the first category (in which the auditor should not use the work of others at all) as the key driver of excessive costs, others identified the principal evidence provision as the real source of their excessive cost concerns. Even if the categories were redefined in such a way as to permit the auditor to use the work of others in more areas, any associated decrease in audit cost would be limited by the principal evidence provision which, if retained, would still require significant original work on the part of the auditor. On the other hand, both investors and auditors generally supported retaining the principal evidence provision as playing an important role in ensuring the independence of the auditor's opinion and preventing inappropriate overreliance on the work of internal auditors and others.

E39. Commenters who both supported and opposed the principal evidence provision indicated that implementing it would be problematic because the nature of the work in an audit of internal control over financial reporting does not lend itself to a purely quantitative measurement. Thus, auditors would be forced to use judgment when determining whether the principal evidence provision has been satisfied.

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E40. In response to the comments, the Board decided that some changes to the guidance on using the work of others were necessary. The Board did not intend to reject the concepts in AU sec. 322 and replace them with a different model. Although AU sec. 322 is designed to apply to an audit of financial statements, the Board concluded that the concepts contained in AU sec. 322 are sound and should be used in an audit of internal control over financial reporting, with appropriate modification to take into account the differences in the nature of the evidence necessary to support an opinion on financial statements and the evidence necessary to support an opinion on internal control effectiveness. The Board also wanted to make clear that the concepts in AU sec. 322 also may be applied, with appropriate auditor judgment, to the relevant work of others.

E41. The Board remained concerned, however, with the possibility that auditors might overrely on the work of internal auditors and others. Inappropriate overreliance can occur in a variety of ways. For example, an auditor might rely on the work of a highly competent and objective internal audit function for proportionately too much of the evidence that provided the basis for the auditor's opinion. Inappropriate overreliance also occurs when the auditor incorrectly concludes that internal auditors have a high degree of competence and objectivity when they do not, perhaps because the auditor did not exercise professional skepticism or due professional care when making his or her evaluation. In either case, the result is the same: unacceptable risk that the auditor's conclusion that internal control over financial reporting is effective is incorrect. For example, federal bank regulators commented that, in their experience with FDICIA, auditors have a tendency to rely too heavily on the work of management and others, further noting that this situation diminishes the independence of the auditor's opinion on control effectiveness.

E42. The Board decided to revise the categories of controls by focusing on the nature of the controls being tested, evaluating the competence and objectivity of the individuals performing the work, and testing the work of others. This allows the auditor to exercise substantial judgment based on the outcome of this work as to the extent to which he or she can make use of the work of internal auditors or others who are suitably qualified.

E43. This standard emphasizes the direct relationship between the assessed level of competence and objectivity and the extent to which the auditor may use the work of others. The Board included this clarification to highlight the special status that a highly competent and objective internal auditor has in the auditor's work as well as to caution against inappropriate overreliance on the work of management and others who would

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be expected to have lower degrees of competence and objectivity in assessing controls. Indeed, the Board noted that, with regard to internal control over financial reporting, internal auditors would normally be assessed as having a higher degree of competence and objectivity than management or others and that an auditor will be able to rely to a greater extent on the work of a highly competent and objective internal auditor than on work performed by others within the company.

E44. The Board concluded that the principal evidence provision is critical to preventing overreliance on the work of others in an audit of internal control over financial reporting. The requirement for the auditor to perform enough of the control testing himself or herself so that the auditor's own work provides the principal evidence for the auditor's opinion is of paramount importance to the auditor's assurance providing the level of reliability that investors expect. However, the Board also decided that the final standard should articulate clearly that the auditor's judgment about whether he or she has obtained the principal evidence required is qualitative as well as quantitative. Therefore, the standard now states, "Because the amount of work related to obtaining sufficient evidence to support an opinion about the effectiveness of controls is not susceptible to precise measurement, the auditor's judgment about whether he or she has obtained the principal evidence for the opinion will be qualitative as well as quantitative. For example, the auditor might give more weight to work performed on pervasive controls and in areas such as the control environment than on other controls, such as controls over low-risk, routine transactions."

E45. The Board also concluded that a better balance could be achieved in the standard by instructing the auditor to factor into the determination of the extent to which to use the work of others an evaluation of the nature of the controls on which others performed their procedures.

E46. Paragraph 112 of the standard provides the following factors the auditor should consider when evaluating the nature of the controls subjected to the work of others:

- The materiality of the accounts and disclosures that the control addresses and the risk of material misstatement.

- The degree of judgment required to evaluate the operating effectiveness of the control (that is, the degree to which the evaluation of the effectiveness of the control requires evaluation of subjective factors rather than objective testing).

- The pervasiveness of the control.

- The level of judgment or estimation required in the account or disclosure.

- The potential for management override of the control.

E47. As these factors increase in significance, the need for the auditor to perform his or her own work on those controls increases. As these factors decrease in significance, the auditor may rely more on the work of others. Because of the nature of controls in the control environment, however, the standard does not allow the auditor to use the work of others to reduce the amount of work he or she performs on such controls. In addition, the standard also does not allow the auditor to use the work of others in connection with the performance of walkthroughs of major classes of transactions because of the high degree of judgment required when performing them (See separate discussion in paragraphs E51 through E57).

E48. The Board decided that this approach was responsive to those who believed that the auditor should be able to use his or her judgment in determining the extent to which to use the work of others. The Board designed the requirement that the auditor's own work must provide the principal evidence for the auditor's opinion as one of the boundaries within which the auditor determines the work he or she must perform himself or herself in the audit of internal control over financial reporting. The other instructions about using the work of others provide more specific direction about how the auditor makes this determination, but allow the auditor significant flexibility to use his or her judgment to determine the work necessary to obtain the principal evidence, and to determine when the auditor can use the work of others rather than perform the work himself or herself. Although some of the directions are specific and definitive, such as the directions for the auditor to perform tests of controls in the control environment and walkthroughs himself or herself, the Board decided that these areas were of such audit importance that the auditor should always perform this testing as part of obtaining the principal evidence for his or her opinion. The Board concluded that this approach appropriately balances the use of auditor judgment and the risk of inappropriate overreliance.

E49. The Board was particularly concerned by comments that issuers might choose to reduce their internal audit staff or the extent of internal audit testing in the absence of a significant change in the proposed standard that would significantly increase the extent to which the auditor may use the work of internal auditors. The Board believes the standard makes clear that an effective internal audit function does permit the auditor to reduce the work that otherwise would be necessary.

E50. Finally, as part of clarifying the linkage between the degree of competence and objectivity of the others and the ability to use their work, the Board decided that additional clarification should be provided on the extent of testing that should be required of the work of others. The Board noted that the interaction of the auditor performing walkthroughs of every significant process and the retention of the principal evidence provision precluded the need for the auditor to test the work of others in every significant account. However, testing the work of others is an important part of an ongoing assessment of their competence and objectivity. Therefore, as part of the emphasis on the direct relationship between the assessed level of competence and objectivity to the extent of the use of the work of others, additional provisions were added discussing how the results of the testing of the work of others might affect the auditor's assessment of competence and objectivity. The Board also concluded that testing the work of others should be clearly linked to an evaluation of the quality and effectiveness of their work.

Walkthroughs

E51. The proposed standard included a requirement that the auditor perform walkthroughs, stating that the auditor should perform a walkthrough for all of the company's significant processes. In the walkthrough, the auditor was to trace all types of transactions and events, both recurring and unusual, from origination through the company's information systems until they were included in the company's financial reports. As stated in the proposed standard, walkthroughs provide the auditor with evidence to:

- Confirm the auditor's understanding of the process flow of transactions;

- Confirm the auditor's understanding of the design of controls identified for all five components of internal control over financial reporting, including those related to the prevention or detection of fraud;

- Confirm that the auditor's understanding of the process is complete by determining whether all points in the process at which misstatements related to each relevant financial statement assertion that could occur have been identified;

- Evaluate the effectiveness of the design of controls; and

- Confirm whether controls have been placed in operation.

E52. A number of commenters expressed strong support for the requirement for the auditor to perform walkthroughs as described in the proposed standard. They agreed that auditors who did not already perform the type of walkthrough described in the proposed standard should perform them as a matter of good practice. These commenters further recognized that the first-hand understanding an auditor obtains from performing these walkthroughs puts the auditor in a much better position to design an effective audit and to evaluate the quality and effectiveness of the work of others. They considered the walkthrough requirement part of "getting back to basics," which they viewed as a positive development.

E53. Some commenters expressed general support for walkthroughs as required procedures, but had concerns about the scope of the work. A number of commenters suggested that requiring walkthroughs of *all* significant processes and *all* types of transactions would result in an overwhelming and unreasonable number of walkthroughs required. Commenters made various suggestions for alleviating this problem, including permitting the auditor to determine, using broad auditor judgment, which classes of transactions to walk through or refining the scope of "all types of transactions" to include some kind of consideration of risk and materiality.

E54. Other commenters believed that required walkthroughs would result in excessive cost if the auditor were prohibited from using the work of others. These commenters suggested that the only way that required walkthroughs would be a reasonable procedure is to permit the auditor to use the work of others. Although commenters varied on whether the auditor's use of the work of others for walkthroughs should be liberal or limited, and whether it should include management or be limited to internal auditors, a large number of commenters suggested that limiting walkthroughs to only the auditor himself or herself was impractical.

E55. The Board concluded that the objectives of the walkthroughs cannot be achieved second-hand. For the objectives to be effectively achieved, the auditor must perform the walkthroughs himself or herself. Several commenters who objected to the prohibition on using the work of internal auditors for walkthroughs described situations in which internal auditors would be better able to effectively perform walkthroughs because internal auditors understood the company's business and controls better than the external auditor and because the external auditor would struggle in performing walkthroughs due to a lack of understanding. The Board observed that these commenters' perspectives support the importance of requiring the external auditor to perform walkthroughs. If auditors struggle to initially perform walkthroughs because their knowledge of the company and its controls is weak, then that situation would only emphasize the necessity for the auditor to increase his or her level of understanding. After considering the nature and extent of the procedures that would be required to achieve these objectives, the Board concluded that performing walkthroughs would be the most efficient means of doing so. The first-hand understanding the auditor will obtain of the company's processes and its controls through the walkthroughs will translate into increased effectiveness and quality throughout the rest of the audit, in a way that cannot be achieved otherwise.

E56. The Board also decided that the scope of the transactions that should be subjected to walkthroughs should be more narrowly defined. To achieve the objectives the Board intended for walkthroughs to accomplish, the auditor should not be forced to perform walkthroughs on what many commenters reasoned was an unreasonably large population. The Board decided that the auditor should be able to use judgment in considering risk and materiality to determine which transactions and events within a given significant process to walk through. As a result, the directions in the standard on determining significant processes and major classes of transactions were expanded, and the population of transactions for which auditors will be required to walk through narrowed by replacing "all types of transactions" with "major classes of transactions."

E57. Although judgments of risk and materiality are inherent in identifying major classes of transactions, the Board decided to also remove from the standard the statement, "walkthroughs are required procedures" as a means of further clarifying that auditor judgment plays an important role in determining the major classes of transactions for which to perform a walkthrough. The Board observed that leading off the discussion of walkthroughs in the standard with such a sentence could be read as setting a tone that diminished the role of judgment in selecting the transactions to walk through. As a result, the directions in the standard on performing walkthroughs begin with, "The auditor should perform at least one walkthrough for each major class of transactions…" The Board's decision to eliminate the statement "walkthroughs are required procedures" should not be viewed as an indication that performing walkthroughs are optional under the standard's directions. The Board believes the auditor might be able to achieve the objectives of a walkthrough by performing a combination of procedures, including inquiry, inspection, observation, and reperformance; however, performing a walkthrough represents the most efficient and effective means of doing so. The auditor's work on the control environment and walkthroughs is an important part of the principal evidence that the auditor must obtain himself or herself.

Small Business Issues

E58. Appendix E of the proposed standard discussed small and medium-sized company considerations. Comments were widely distributed on this topic. A number of commenters indicated that the proposed standard gave adequate 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 companies. Other commenters, particularly smaller issuers and smaller audit firms, indicated that the proposed standard needed to provide much more detail on how internal control over financial reporting could be different at a small or medium-sized issuer and how the auditor's approach could differ. Some of these commenters indicated that the concepts articulated in the Board's proposing release concerning accommodations for small and medium-sized companies were not carried through to the proposed standard itself.

E59. On the other hand, other commenters, particularly large audit firms and investors, expressed views that the proposed standard went too far in creating too much of an accommodation for small and medium-sized issuers. In fact, many believed that the proposed standard permitted those issuers to have less effective internal control over financial reporting than larger issuers, while providing guidance to auditors permitting them to perform less extensive testing at those small and medium-sized issuers than they might have at larger issuers. These commenters stressed that effective internal control over financial reporting is equally important at small and medium-sized issuers. Some commenters also expressed concerns that the guidance in proposed Appendix E appeared to emphasize that the actions of senior management, if carried out with integrity, could offset deficiencies in internal control over financial reporting, such as the lack of written policies and procedures. Because the risk of management override of controls is higher in these types of environments, such commenters were concerned that the guidance in proposed Appendix E might result in an increased fraud risk at small and medium-sized issuers. At a minimum, they argued, the interpretation of Appendix E might result in a dangerous expectation gap for users of their internal control reports. Some commenters who were of this view suggested that Appendix E be deleted altogether or replaced with a reference to the report of the Committee of Sponsoring Organizations (COSO) of the Treadway Commission, *Internal*

Control—Integrated Framework, which they felt contained sufficient guidance on small and medium-sized company considerations.

E60. Striking an appropriate balance regarding the needs of smaller issuers is particularly challenging. The Board considered cautionary views about the difficulty in expressing accommodations for small and medium-sized companies without creating an inappropriate second class of internal control effectiveness and audit assurance. Further, the Board noted that the COSO framework currently provides management and the auditor with more guidance and flexibility regarding small and medium-sized companies than the Board had provided in the proposed Appendix E. As a result, the Board eliminated proposed Appendix E and replaced the appendix with a reference to COSO in paragraph 15 of the standard. The Board believes providing internal control criteria for small and medium-sized companies within the internal control framework is more appropriately within the purview of COSO. Furthermore, the COSO report was already tailored for special small and medium-sized company considerations. The Board decided that emphasizing the existing guidance within COSO was the best way of recognizing the special considerations that can and should be given to small and medium-sized companies without inappropriately weakening the standard to which these smaller entities should, nonetheless, be held. If additional tailored guidance on the internal control framework for small and medium-sized companies is needed, the Board encourages COSO, or some other appropriate body, to develop this guidance.

Evaluation of the Effectiveness of the Audit Committee

E61. The proposed standard identified a number of circumstances that, because of their likely significant negative effect on internal control over financial reporting, are significant deficiencies as well as *strong indicators* that a material weakness exists. A particularly notable significant deficiency and strong indicator of a material weakness was the ineffective oversight by the audit committee of the company's external financial reporting and internal control over financial reporting. In addition, the proposed standard required the auditor to evaluate factors related to the effectiveness of the audit committee's oversight of the external financial reporting process and the internal control over financial reporting.

E62. This provision related to evaluating the effectiveness of the audit committee was included in the proposed standard for two primary reasons. First, the Board initially decided that, because of the significant role that the audit committee has in the control environment and monitoring components of internal control over financial reporting, an

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ineffective audit committee is a gravely serious control weakness that is strongly indicative of a material weakness. Most auditors should have already been reaching this conclusion when confronted with an obviously ineffective audit committee. Second, highlighting the adverse consequences of an ineffective audit committee would, perhaps, further encourage weak audit committees to improve.

E63. Investors supported this provision. They expressed an expectation that the auditor would evaluate the audit committee's effectiveness and speak up if the audit committee was determined to be ineffective. Investors drew a link among restoring their confidence, audit committees having new and enhanced responsibilities, and the need for assurance that audit committees are, in fact, meeting their responsibilities.

E64. Auditors also were generally supportive of such an evaluation. However, many requested that the proposed standard be refined to clearly indicate that the auditor's responsibility to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is not a separate and distinct evaluation. Rather, the evaluation is one element of the auditor's overall understanding and assessment of the company's control environment and monitoring components. Some commenters suggested that, in addition to needing clarification of the auditor's responsibility, the auditor would have difficulty in evaluating all of the factors listed in the proposed standard, because the auditor's normal interaction with the audit committee would not provide sufficient basis to conclude on some of those factors.

E65. Issuers and some others were opposed to the auditor evaluating the effectiveness of the audit committee on the fundamental grounds that such an evaluation would represent an unacceptable conflict of interest. Several commenters shared the view that this provision would reverse an important improvement in governance and audit quality. Whereas the auditor was formerly retained and compensated by management, the Act made clear that these responsibilities should now be those of the audit committee. In this way, commenters saw a conflict of interest being remedied. Requiring the auditor to evaluate the effectiveness of the audit committee led commenters to conclude that the same kind of conflict of interest was being reestablished. These commenters also believed that the auditor would not have a sufficient basis on which to evaluate the effectiveness of the audit committee because the auditor does not have complete and free access to the audit committee, does not have appropriate expertise to evaluate audit committee members (who frequently are more experienced businesspeople than the auditor), does not have the legal expertise to make determinations about some of the specific factors listed in the proposed standard, and other shortcomings. These commenters also emphasized that the board of directors' evaluation of the audit committee is important and that the proposed standard could be read to supplant this important evaluation with that of the auditor's.

E66. The Board concluded that this provision should be retained but decided that clarification was needed to emphasize that the auditor's evaluation of the audit committee was not a separate evaluation but, rather, was made as part of the auditor's evaluation of the control environment and monitoring components of internal control over financial reporting. The Board reasoned that clarifying both this context and limitation on the auditor's evaluation of the audit committee would also address, to some degree, the conflict-of-interest concerns raised by other commenters. The Board also observed, however, that conflict is, to some extent, inherent in the duties that society expects of auditors. Just as auditors were expected in the past to challenge management when the auditor believed a material misstatement of the financial statements or material weakness in internal control over financial reporting existed, the auditor similarly is expected to speak up when he or she believes the audit committee is ineffective in its oversight.

E67. The Board decided that when the auditor is evaluating the control environment and monitoring components, if the auditor concludes that the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is ineffective, the auditor should be strongly encouraged to consider that situation a material weakness and, at a minimum, a significant deficiency. The objective of the evaluation is not to grade the effectiveness of the audit committee along a scale. Rather, in the course of performing procedures related to evaluating the effectiveness of the control environment and monitoring components, including evaluating factors related to the effectiveness of the audit committee's oversight, if the auditor concludes that the audit committee's oversight of the external financial reporting and internal control over financial reporting is ineffective, then the auditor should consider that a strong indicator of a material weakness.

E68. The Board concluded that several refinements should be made to this provision. As part of emphasizing that the auditor's evaluation of the audit committee is to be made as part of evaluating the control environment and not as a separate evaluation, the Board determined that the evaluation factors should be modified. The factors that addressed compliance with listing standards and sections of the Act were deleted, because those factors were specifically criticized in comment letters as being either outside the scope of the auditor's expertise or outside the scope of internal control over financial reporting. The Board also believed that those factors were not significant to the type of evaluation the auditor was expected to make of the audit committee. The Board decided to add the following factors, which are based closely on factors described in COSO, as relevant to evaluating those who govern, including the audit committee:

- Extent of direct and independent interaction with key members of financial management, including the chief financial officer and chief accounting officer.
- Degree to which difficult questions are raised and pursued with management and the auditor, including questions that indicate an understanding of the critical accounting policies and judgmental accounting estimates.
- Level of responsiveness to issues raised by the auditor, including those required to be communicated by the auditor to the audit committee.

E69. The Board also concluded that the standard should explicitly acknowledge that the board of directors is responsible for evaluating the effectiveness of the audit committee and that the auditor's evaluation of the control environment is not intended to supplant those evaluations. In addition, the Board concluded that, in the event the auditor determines that the audit committee's oversight is ineffective, the auditor should communicate that finding to the full board of directors. This communication should occur regardless of whether the auditor concludes that the condition represents a significant deficiency or a material weakness, and the communication should take place in addition to the normal communication requirements that attach to those deficiencies.

Definitions of Significant Deficiency and Material Weakness

E70. As part of developing the proposed standard, the Board evaluated the existing definitions of significant deficiency (which the SEC defined as being the same as a reportable condition) and material weakness to determine whether they would permit the most effective implementation of the internal control reporting requirements of the Act.

E71. AU sec. 325, *Communication of Internal Control Related Matters Noted in an Audit*, defined a material weakness as follows:

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> A *material weakness* in internal control is 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.

E72. The framework that defined a material weakness focused on likelihood of and magnitude for evaluating a weakness. The Board decided that this framework would facilitate effective implementation of the Act's internal control reporting requirements; therefore, the Board's proposed definitions focused on likelihood and magnitude. However, as part of these deliberations, the Board decided that likelihood and magnitude needed to be defined in terms that would encourage more consistent application.

E73. Within the existing definition of material weakness, the magnitude of "material in relation to the financial statements" was well supported by the professional standards, SEC rules and guidance, and other literature. However, the Board decided that the definition of likelihood would be improved if it used "more than remote" instead of "relatively low level." FASB Statement No. 5, *Accounting for Contingencies* (FAS No. 5) defines "remote." The Board decided that, because auditors were familiar with the application of the likelihood definitions in FAS No. 5, using "more than remote" in the definition of material weakness would infuse the evaluation of whether a control deficiency was a material weakness with the additional consistency that the Board wanted to encourage.

E74. AU sec. 325 defined *reportable conditions* as follows:

> …matters coming to the auditor's attention that, in his judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of internal control, which could adversely affect the organization's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements.

E75. The Board observed that this definition makes the determination of whether a condition is reportable solely a matter of the auditor's judgment. The Board believed that this definition was insufficient for purposes of the Act because management also needs a definition to determine whether a deficiency is significant and that the definition

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should be the same as the definition used by the auditor. Furthermore, using this existing definition, the auditor's judgment could never be questioned.

E76. The Board decided that the same framework that represented an appropriate framework for defining a material weakness also should be used for defining a significant deficiency. Although auditor judgment is integral and essential to the audit process (including in determining the severity of control weaknesses), auditors, nonetheless, must be accountable for their judgments. Increasing the accountability of auditors for their judgments about whether a condition represents a significant deficiency and increasing the consistency with which those judgments are made are interrelated. Hence, the same framework of likelihood and magnitude were applied in the Board's proposed definition of significant deficiency.

E77. In applying the likelihood and magnitude framework to defining a significant deficiency, the Board decided that the "more than remote" likelihood of occurrence used in the definition of material weakness was the best benchmark. In terms of magnitude, the Board decided that "more than inconsequential" should be the threshold for a significant deficiency.

E78. A number of commenters were supportive of the definitions in the proposed standard. These commenters believed the definitions were an improvement over the previous definitions, used terms familiar to auditors, and would promote increased consistency in evaluations.

E79. Most commenters, however, objected to these definitions. The primary, over-arching objection was that these definitions set too low a threshold for the reporting of significant deficiencies. Some commenters focused on "more than remote" likelihood as the driver of an unreasonably low threshold, while others believed "more than inconsequential" in the definition of significant deficiency was the main culprit. While some commenters understood "more than inconsequential" well enough, others indicated significant concerns that this represented a new term of art that needed to be accompanied by a clear definition of "inconsequential" as well as supporting examples. Several commenters suggested retaining the likelihood and magnitude approach to a definition but suggested alternatives for likelihood (such as reasonably likely, reasonably possible, more likely than not, probable) and magnitude (such as material, significant, insignificant).

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E80. Some commenters suggested that the auditing standard retain the existing definitions of material weakness and significant deficiency, consistent with the SEC's final rules implementing Section 404. In their final rules, the SEC tied management's assessment to the existing definitions of material weakness and significant deficiency (through the existing definition of a reportable condition) in AU sec. 325. These commenters suggested that, if the auditing standard used a different definition, a dangerous disconnect would result, whereby management would be using one set of definitions under the SEC's rules and auditors would be using another set under the Board's auditing standards. They further suggested that, absent rulemaking by the SEC to change its definitions, the Board should simply defer to the existing definitions.

E81. A number of other commenters questioned the reference to "a misstatement of the annual or interim financial statements" in the definitions, with the emphasis on why "interim" financial statements were included in the definition, since Section 404 required only an annual assessment of internal control over financial reporting effectiveness, made as of year-end. They questioned whether this definition implied that the auditor was required to identify deficiencies that could result in a misstatement in interim financial statements; they did not believe that the auditor should be required to plan his or her audit of internal control over financial reporting at a materiality level of the interim financial statements.

E82. The Board ultimately concluded that focusing the definitions of material weakness and significant deficiency on likelihood of misstatement and magnitude of misstatement provides the best framework for evaluating deficiencies. Defaulting to the existing definitions would not best serve the public interest nor facilitate meaningful and effective implementation of the auditing standard.

E83. The Board observed that the SEC's final rules requiring management to report on internal control over financial reporting define material weakness, for the purposes of the final rules, as having "the same meaning as the definition under GAAS and attestation standards." Those rules state:

> The term "significant deficiency" has the same meaning as the term "reportable condition" as used in AU §325 and AT§501. The terms "material weakness" and "significant deficiency" both represent deficiencies in the design or operation of internal control that could adversely affect a company's ability to record, process, summarize and report financial data consistent with the assertions of management in the company's financial statements, with a "material weakness"

constituting a greater deficiency than a "significant deficiency." Because of this relationship, it is our judgment that an aggregation of significant deficiencies could constitute a material weakness in a company's internal control over financial reporting.[4/]

E84. The Board considered the SEC's choice to cross-reference to generally accepted auditing standards (GAAS) and the attestation standards as the means of defining these terms, rather than defining them outright within the final rules, noteworthy as it relates to the question of whether any disconnect could result between auditors' and managements' evaluations if the Board changed the definitions in its standards. Because the standard changes the definition of these terms within the interim standards, the Board believes the definitions are, therefore, changed for both auditors' and managements' purposes.

E85. The Board noted that commenters who were concerned that the definitions in the proposed standard set too low of a threshold for significant deficiencies and material weaknesses believed that the proposed standard required that each control deficiency be evaluated in isolation. The intent of the proposed standard was that control deficiencies should first be evaluated individually; the determination as to whether they are significant deficiencies or material weaknesses should be made considering the effects of compensating controls. The effect of compensating controls should be taken into account when assessing the likelihood of a misstatement occurring and not being prevented or detected. The proposed standard illustrated this type of evaluation, including the effect of compensating controls when assessing likelihood, in the examples in Appendix D. Based on the comments received, however, the Board determined that additional clarification within the standard was necessary to emphasize the importance of considering compensating controls when evaluating the likelihood of a misstatement occurring. As a result, the note to paragraph 10 was added.

E86. The Board concluded that considering the effect of compensating controls on the likelihood of a misstatement occurring and not being prevented or detected sufficiently addressed the concerns that the definitions set too low a threshold. For example, several issuer commenters cited concerns that the proposed definitions precluded a

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[4/] See footnote 73 to *Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, Securities and Exchange Commission Release No. 33-8238 (June 5, 2003) [68 FR 36636].

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rational cost-benefit analysis of whether to correct a deficiency. These issuers believed they would be compelled to correct deficiencies (because the deficiencies would be considered to be at least significant deficiencies) in situations in which management had made a previous conscious decision that the costs of correcting the deficiency outweighed the benefits. The Board observed that, in cases in which management has determined not to correct a known deficiency based on a cost-benefit analysis, effective compensating controls usually lie at the heart of management's decision. The standard's use of "likelihood" in the definition of a significant deficiency or material weakness accommodates such a consideration of compensating controls. If a deficiency is effectively mitigated by compensating controls, then the likelihood of a misstatement occurring and not being prevented or detected may very well be remote.

E87. The Board disagreed with comments that "more than inconsequential" was too low a threshold; however, the Board decided the term "inconsequential" needed additional clarity. The Board considered the term "inconsequential" in relation to the SEC's guidance on audit requirements and materiality. Section 10A(b)(1)(B)[5/] describes the auditor's communication requirements when the auditor detects or otherwise becomes aware of information indicating that an illegal act has or may have occurred, "unless the illegal act is clearly inconsequential." Staff Accounting Bulletin (SAB) No. 99, *Materiality*, provides the most recent and definitive guidance on the concept of materiality as it relates to the financial reporting of a public company. SAB No. 99 uses the term "inconsequential" in several places to draw a distinction between amounts that are not material. SAB No. 99 provides the following guidance to assess the significance of a misstatement:

> Though the staff does not believe that registrants need to make finely calibrated determinations of significance with respect to immaterial items, plainly it is "reasonable" to treat misstatements whose effects are clearly inconsequential differently than more significant ones.

E88. The discussion in the previous paragraphs provided the Board's context for using "material" and "more than inconsequential" for the magnitude thresholds in the standard's definitions. "More than inconsequential" indicates an amount that is less than material yet has significance.

[5/] See Section 10A of the Securities Exchange Act of 1934, 15 U.S.C., 78j-1.

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E89. The Board also considered the existing guidance in the Board's interim standards for evaluating materiality and accumulating audit differences in a financial statement audit. Paragraph .41 of AU sec. 312, *Audit Risk and Materiality in Conducting an Audit,* states:

> In aggregating likely misstatements that the entity has not corrected, pursuant to paragraphs .34 and .35, the auditor may designate an amount below which misstatements need not be accumulated. This amount should be set so that any such misstatements, either individually or when aggregated with other such misstatements, would not be material to the financial statements, after the possibility of further undetected misstatements is considered.

E90. The Board considered the discussion in AU sec. 312 that spoke specifically to evaluating differences individually *and in the aggregate*, as well as to considering the possibility of additional undetected misstatements, important distinguishing factors that should be carried through to the evaluation of whether a control deficiency represents a significant deficiency because the magnitude of the potential misstatement is more than inconsequential.

E91. The Board combined its understanding of the salient concepts in AU sec. 312 and the SEC guidance on materiality to develop the following definition of inconsequential:

> A misstatement is *inconsequential* if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, either individually or when aggregated with other misstatements, would clearly be immaterial to the financial statements. If a reasonable person could not reach such a conclusion regarding a particular misstatement, that misstatement is *more than inconsequential.*

E92. Finally, the inclusion of *annual or interim financial statements* in the definitions rather than just "annual financial statements" was intentional and, in the Board's opinion, closely aligned with the spirit of what Section 404 seeks to accomplish. However, the Board decided that this choice needed clarification within the auditing standard. The Board did not intend the inclusion of the interim financial statements in the definition to require the auditor to perform *an audit of internal control over financial reporting* at each interim date. Rather, the Board believed that the SEC's definition of internal control over financial reporting included all financial reporting that a public company makes publicly available. In other words, internal control over financial reporting includes controls over the preparation of annual and quarterly financial statements. Thus, an evaluation of internal control over financial reporting as of year-end encompasses controls over the annual financial reporting and quarterly financial reporting as such controls exist at that point in time.

E93. Paragraphs 76 and 77 of the standard clarify this interpretation, as part of the discussion of the period-end financial reporting process. The period-end financial reporting process includes procedures to prepare both annual and quarterly financial statements.

Strong Indicators of Material Weaknesses and DeFacto Significant Deficiencies

E94. The proposed standard identified a number of circumstances that, because of their likely significant negative effect on internal control over financial reporting, are significant deficiencies as well as strong indicators that a material weakness exists. The Board developed this list to promote increased rigor and consistency in auditors' evaluations of weaknesses. For the implementation of Section 404 of the Act to achieve its objectives, the public must have confidence that all material weaknesses that exist as of the company's year-end will be publicly reported. Historically, relatively few material weaknesses have been reported by the auditor to management and the audit committee. That condition is partly due to the nature of a financial statement audit. In an audit of only the financial statements, the auditor does not have a detection responsibility for material weaknesses in internal control; such a detection responsibility is being newly introduced for all public companies through Sections 103 and 404 of the Act. However, the Board was concerned about instances in which auditors had identified a condition that should have been, but was not, communicated as a material weakness. The intention of including the list of strong indicators of material weaknesses in the proposed standard was to bring further clarity to conditions that were likely to be material weaknesses in internal control and to create more consistency in auditors' evaluations.

E95. Most commenters were generally supportive of a list of significant deficiencies and strong indicators of the existence of material weaknesses. They believed such a list provided instructive guidance to both management and the auditor. Some commenters, however, disagreed with the proposed approach of providing such a list. They believed that the determination of the significance of a deficiency should be left entirely to auditor judgment. A few commenters requested clarification of the term

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"strong indicator" and specific guidance on how and when a "strong indicator" could be overcome. A number of commenters expressed various concerns with individual circumstances included in the list.

- *Restatement of previously issued financial statements to reflect the correction of a misstatement*. Some commenters expressed concern about the kinds of restatements that would trigger this provision. A few mentioned the specific instance in which the restatement reflected the SEC's subsequent view of an accounting matter when the auditor, upon reevaluation, continued to believe that management had reasonable support for its original position. They believed this specific circumstance would not necessarily indicate a significant deficiency in internal control over financial reporting. Others commented that a restatement of previously issued financial statements would indicate a significant deficiency and strong indicator of a material weakness *in the prior period* but not necessarily in the current period.

- *Identification by the auditor of a material misstatement in financial statements in the current period that was not initially identified by the company's internal control over financial reporting (even if management subsequently corrects the misstatement)*. Several commenters, issuers and auditors alike, expressed concern about including this circumstance on the list. They explained that, frequently, management is completing the preparation of the financial statements at the same time that the auditor is completing his or her auditing procedures. In the face of this "strong indicator" provision, a lively debate of "who found it first" would ensue whenever the auditor identifies a misstatement that management subsequently corrects. Another argument is that the company's controls would have detected a misstatement identified by the auditor if the controls had an opportunity to operate (that is, the auditor performed his or her testing before the company's controls had an opportunity to operate). Several issuers indicated that they would prevent this latter situation by delaying the auditor's work until the issuers had clearly completed their entire period-end financial reporting process – a delay they viewed as detrimental.

- *For larger, more complex entities, the internal audit function or the risk assessment function is ineffective*. Several commenters asked for specific factors the auditor was expected to use to assess the effectiveness of these functions.

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- *For complex entities in highly regulated industries, an ineffective regulatory compliance function.* Several commenters, particularly issuers in highly regulated industries, objected to the inclusion of this circumstance because they believed this to be outside the scope of internal control over financial reporting. (They agreed that this would be an internal control-related matter, but one that falls into operating effectiveness and compliance with laws and regulations, not financial reporting.) Many of these commenters suggested that this circumstance be deleted from the list altogether. Fewer commenters suggested that this problem could be addressed by simply clarifying that this circumstance is limited to situations in which the ineffective regulatory function relates solely to those aspects for which related violations of laws and regulations could have a direct and material effect on the financial statements.

- *Identification of fraud of any magnitude on the part of senior management*. Several commenters expressed concern that the inclusion of this circumstance created a detection responsibility for the auditor such that the auditor would have to plan and perform procedures to detect fraud *of any magnitude* on the part of senior management. Others expressed concern that identification of fraud on the part of senior management by the company's system of internal control over financial reporting might indicate that controls were operating effectively rather than indicating a significant deficiency or material weakness. Still others requested clarification on how to determine who constituted "senior management."

E96. A couple of commenters also suggested that an ineffective control environment should be added to the list.

E97. The Board concluded that the list of significant deficiencies and strong indicators of material weakness should be retained. Such a list will promote consistency in auditors' and managements' evaluations of deficiencies consistent with the definitions of significant deficiency and material weakness. The Board also decided to retain the existing structure of the list. Although the standard leaves auditor judgment to determine whether those deficiencies are material weaknesses, the existence of one of the listed deficiencies is by definition a significant deficiency. Furthermore, the "strong indicator" construct allows the auditor to factor extenuating or unique circumstances into the evaluation and possibly to conclude that the situation does not represent a material weakness, rather, only a significant deficiency.

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E98. The Board decided that further clarification was not necessary within the standard itself addressing specifically how and when a "strong indicator" can be overcome. The term "strong indicator" was selected as opposed to the stronger "presumption" or other such term precisely because the Board did not intend to provide detailed instruction on how to overcome such a presumption. It is, nevertheless, the Board's view that auditors should be biased toward considering the listed circumstances as material weaknesses.

E99. The Board decided to clarify several circumstances included in the list:

- *Restatement of previously issued financial statements to reflect the correction of a misstatement*. The Board observed that the circumstance in which a restatement reflected the SEC's subsequent view of an accounting matter, when the auditor concluded that management had reasonable support for its original position, might present a good example of only a significant deficiency and not a material weakness. However, the Board concluded that requiring this situation to, nonetheless, be considered by definition a significant deficiency is appropriate, especially considering that the primary result of the circumstance being considered a significant deficiency is the communication of the matter to the audit committee. Although the audit committee might already be well aware of the circumstances of any restatement, a restatement to reflect the SEC's view on an accounting matter at least has implications for the quality of the company's accounting principles, which is already a required communication to the audit committee.

  With regard to a restatement being a strong indicator of a material weakness in the prior period but not necessarily the current period, the Board disagreed with these comments. By virtue of the restatement occurring during the current period, the Board views it as appropriate to consider that circumstance a strong indicator that a material weakness existed during the current period. Depending on the circumstances of the restatement, however, the material weakness may also have been corrected during the current period. The construct of the standard does not preclude management and the auditor from determining that the circumstance was corrected prior to year-end and, therefore, that a material weakness did not exist at year-end. The emphasis here is that the circumstance is a strong indicator that a material weakness exists; management and the auditor will separately need to determine whether it has been corrected. The Board decided that no further clarification was needed in this regard.

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- *Identification by the auditor of a material misstatement in financial statements in the current period that was not initially identified by the company's internal control over financial reporting (even if management subsequently corrects the misstatement)*. Regarding the "who-found-it-first" dilemma, the Board recognizes that this circumstance will present certain implementation challenges. However, the Board decided that none of those challenges were so significant as to require eliminating this circumstance from the list.

  When the Board developed the list of strong indicators, the Board observed that it is not uncommon for the financial statement auditor to identify material misstatements in the course of the audit that are corrected by management prior to the issuance of the company's financial statements. In some cases, management has relied on the auditor to identify misstatements in certain financial statement items and to propose corrections in amount, classification, or disclosure. With the introduction of the requirement for management and the auditor to report on the effectiveness of internal control over financial reporting, it becomes obvious that this situation is unacceptable, unless management is willing to accept other than an unqualified report on the internal control effectiveness. (This situation also raises the question as to the extent management may rely on the annual audit to produce accurate and fair financial statements without impairing the auditor's independence.) This situation is included on the list of strong indicators because the Board believes it will encourage management and auditors to evaluate this situation with intellectual honesty and to recognize, first, that the company's internal control should provide reasonable assurance that the company's financial statements are presented fairly in accordance with generally accepted accounting principles.

  Timing might be a concern for some issuers. However, to the extent that management takes additional steps to ensure that the financial information is correct prior to providing it to their auditors, this may, at times, result in an improved control environment. When companies and auditors work almost simultaneously on completing the preparation of the annual financial statements and the audit, respectively, the role of the auditor can blur with the responsibility of management. In the year-end rush to complete the annual report, some companies might have come to rely on their auditors as a "control" to further ensure no misstatements are accidentally reflected in the financial statements. The principal burden seems to be for management's work schedule and administration of their financial reporting deadlines to allow the auditor sufficient time to complete his or her procedures.

Further, if the auditor initially identified a material misstatement in the financial statements but, given the circumstances, determined that management ultimately would have found the misstatement, the auditor could determine that the circumstance was a significant deficiency but not a material weakness. The Board decided to retain the provision that this circumstance is at least a significant deficiency because reporting such a circumstance to the audit committee would always be appropriate.

- *For larger, more complex entities, the internal audit function or the risk assessment function is ineffective*. Relatively few commenters requested clarification on how to evaluate these functions. The Board expects that most auditors will not have trouble making this evaluation. Similar to the audit committee evaluation, this evaluation is not a separate evaluation of the internal audit or risk assessment functions but, rather, is a way of requiring the auditor to speak up if either of these functions is obviously ineffective at an entity that needs them to have an effective monitoring or risk assessment component. Unlike the audit committee discussion, most commenters seemed to have understood that this was the context for the internal audit and risk assessment function evaluation. Nonetheless, the Board decided to add a clarifying note to this circumstance emphasizing the context.

- *For complex entities in highly regulated industries, an ineffective regulatory compliance function*. The Board decided that this circumstance, as described in the proposed standard, would encompass aspects that are outside internal control over financial reporting (which would, of course, be inappropriate for purposes of this standard given its definition of internal control over financial reporting). The Board concluded that this circumstance should be retained, though clarified, to only apply to those aspects of an ineffective regulatory compliance function that could have a material effect on the financial statements.

- *Identification of fraud of any magnitude on the part of senior management.* The Board did not intend to create any additional detection responsibility for the auditor; rather, it intended that this circumstance apply to fraud on the part of senior management that came to the auditor's attention, regardless of amount. The Board decided to clarify the standard to make this clear. The Board noted

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that identification of fraud by the company's system of internal control over financial reporting might indicate that controls were operating effectively, except when that fraud involves senior management. Because of the critical role of tone-at-the-top in the overall effectiveness of the control environment and due to the significant negative evidence that fraud of any magnitude on the part of senior management reflects on the control environment, the Board decided that it is appropriate to include this circumstance in the list, regardless of whether the company's controls detected the fraud. The Board also decided to clarify who is included in "senior management" for this purpose.

E100. The Board agreed that an ineffective control environment was a significant deficiency and a strong indicator that a material weakness exists and decided to add it to the list.

Independence

E101. The proposed standard explicitly prohibited the auditor from accepting an engagement to provide an internal control-related service to an audit client that has not been specifically pre-approved by the audit committee. In other words, the audit committee would not be able to pre-approve internal control-related services as a category. The Board did not propose any specific guidance on permissible internal control-related services in the proposed standard but, rather, indicated its intent to conduct an in-depth evaluation of independence requirements in the future and highlighted its ability to amend the independence information included in the standard pending the outcome of that analysis.

E102. Comments were evenly split among investors, auditors, and issuers who believed the existing guidance was sufficient versus those who believed the Board should provide additional guidance. Commenters who believed existing guidance was sufficient indicated that the SEC's latest guidance on independence needed to be given more time to take effect given its recency and because existing guidance was clear enough. Commenters who believed more guidance was necessary suggested various additions, from more specificity about permitted and prohibited services to a sweeping ban on any internal control-related work for an audit client. Other issuers commented about auditors participating in the Section 404 implementation process at their audit clients in a manner that could be perceived as affecting their independence.

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E103. Some commenters suggested that the SEC should change the pre-approval requirements on internal control-related services to specific pre-approval. Another commenter suggested that specific pre-approval of all internal control-related services would pose an unreasonable burden on the audit committee and suggested reverting to pre-approval by category.

E104. The Board clearly has the authority to set independence standards as it may deem necessary or appropriate in the public interest or for the protection of investors. Given ongoing concerns about the appropriateness of auditors providing these types of services to audit clients, the fact-specific nature of each engagement, and the critical importance of ongoing audit committee oversight of these types of services, the Board continues to believe that specific pre-approval of internal control-related services is a logical step that should not pose a burden on the audit committee beyond that which effective oversight of financial reporting already entails. Therefore, the standard retains this provision unchanged.

Requirement for Adverse Opinion When a Material Weakness Exists

E105. The existing attestation standard (AT sec. 501) provides that, when the auditor has identified a material weakness in internal control over financial reporting, depending on the significance of the material weakness and its effect on the achievement of the objectives of the control criteria, the auditor may qualify his or her opinion ("except for the effect of the material weakness, internal control over financial reporting was effective") or express an adverse opinion ("internal control over financial reporting was not effective").

E106. The SEC's final rules implementing Section 404 state that, "Management is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting." In other words, in such a case, management must conclude that internal control over financial reporting is not effective (that is, a qualified or "except-for" conclusion is not acceptable).

E107. The Board initially decided that the reporting model for the auditor should follow the required reporting model for management. Therefore, because management is required to express an "adverse" conclusion in the event a material weakness exists, the auditor's opinion also must be adverse. The proposed standard did not permit a qualified audit opinion in the event of a material weakness.

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E108. Comments received on requiring an adverse opinion when a material weakness exists were split. A large number affirmed that this seemed to be the only logical approach, based on a philosophical belief that if a material weakness exists, then internal control over financial reporting is ineffective. These commenters suggested that permitting a qualified opinion would be akin to creating another category of control deficiency—material weaknesses that were really material (resulting in an adverse opinion) and material weaknesses that weren't so material (resulting in a qualified opinion).

E109. A number of commenters agreed that the auditor's report must follow the same model as management' reporting, but they believe strongly that the SEC's guidance for management accommodated either a qualified or adverse opinion when a material weakness existed.

E110. These commenters cited Section II.B.3.c of the SEC Final Rule and related footnote no. 72:

> The final rules therefore preclude management from determining that a company's internal control over financial reporting is effective if it identifies one or more material weaknesses in the company's internal control over financial reporting. This is consistent with interim attestation standards. See AT sec. 501.

E111. They believe this reference to the interim attestation standard in the SEC Final Rule is referring to paragraph .37 of AT sec. 501, which states, in part,

> Therefore, the presence of a material weakness will preclude the practitioner from concluding that the entity has effective internal control. However, depending on the significance of the material weakness and its effect on the achievement of the objectives of the control criteria, the practitioner may qualify his or her opinion (that is, express an opinion that internal control is effective "except for" the material weakness noted) or may express an adverse opinion.

E112. Their reading of the SEC Final Rule and the interim attestation standard led them to conclude that it would be appropriate for the auditor to express either an adverse opinion or a qualified "except-for" opinion about the effectiveness of the company's internal control over financial reporting depending on the circumstances.

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E113. Some commenters responded that they thought a qualified opinion would be appropriate in certain cases, such as an acquisition close to year-end (too close to be able to assess controls at the acquiree).

E114. After additional consultation with the SEC staff about this issue, the Board decided to retain the proposed reporting model in the standard. The primary reason for that decision was the Board's continued understanding that the SEC staff would expect only an adverse conclusion from management (not a qualified conclusion) in the event a material weakness existed as of the date of management's report.

E115. The commenters who suggested that a qualified opinion should be permitted in certain circumstances, such as an acquisition close to year-end, were essentially describing scope limitations. The standard permits a qualified opinion, a disclaimer of opinion, or withdrawal from the engagement if there are restrictions on the scope of the engagement. As it relates specifically to acquisitions near year-end, this is another case in which the auditor's model needs to follow the model that the SEC sets for management. The standard added a new paragraph to Appendix B permitting the auditor to limit the scope of his or her work (without referring to a scope limitation in the auditor's report) in the same manner that the SEC permits management to limit its assessment. In other words, if the SEC permits management to exclude an entity acquired late in the year from a company's assessment of internal control over financial reporting, then the auditor could do the same.

Rotating Tests of Controls

E116. The proposed standard directed the auditor to perform tests of controls on "relevant assertions" rather than on "significant controls." To comply with those requirements, the auditor would be required to apply tests to those controls that are important to presenting each relevant assertion in the financial statements. The proposed standard emphasized controls that affect relevant assertions because those are the points at which misstatements could occur. However, it is neither necessary to test all controls nor to test redundant controls (unless redundancy is itself a control objective, as in the case of certain computer controls). Thus, the proposed standard encouraged the auditor to identify and test controls that addressed the primary areas in which misstatements could occur, yet limited the auditor's work to only the necessary controls.

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E117. Expressing the extent of testing in this manner also simplified other issues involving extent of testing decisions from year to year (the so-called "rotating tests of controls" issue). The proposed standard stated that the auditor should vary testing from year to year, both to introduce unpredictability into the testing and to respond to changes at the company. However, the proposed standard maintained that each year's audit must stand on its own. Therefore, the auditor must obtain evidence of the effectiveness of controls over all relevant assertions related to all significant accounts and disclosures every year.

E118. Auditors and investors expressed support for these provisions as described in the proposed standard. In fact, some commenters compared the notion of rotating tests of control in an audit of internal control over financial reporting to an auditor testing accounts receivable only once every few years in a financial statement audit. Permitting so-called rotation of testing would compromise the auditor's ability to obtain reasonable assurance that his or her opinion was correct.

E119. Others, especially issuers concerned with limiting costs, strongly advocated some form of rotating tests of controls. Some commenters suggested that the auditor should have broad latitude to perform some cursory procedures to determine whether any changes had occurred in controls and, if not, to curtail any further testing in that area. Some suggested that testing as described in the proposed standard should be required in the first year of the audit (the "baseline" year) and that in subsequent years the auditor should be able to reduce the required testing. Others suggested progressively less aggressive strategies for reducing the amount of work the auditor should be required to perform. In fact, several commenters (primarily internal auditors) described "baselining" controls as an important strategy to retain. They argued, for example, that IT application controls, once tested, could be relied upon (without additional testing) in subsequent years as long as general controls over program changes and access controls were effective and continued to be tested.

E120. The Board concluded that each year's audit must stand on its own. Cumulative audit knowledge is not to be ignored; some natural efficiencies will emerge as the auditor repeats the audit process. For example, the auditor will frequently spend less time to obtain the requisite understanding of the company's internal control over financial reporting in subsequent years compared with the time necessary in the first year's audit of internal control over financial reporting. Also, to the extent that the auditor has previous knowledge of control weaknesses, his or her audit strategy should, of course, reflect that knowledge. For example, a pattern of mistakes in prior periods is

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usually a good indicator of the areas in which misstatements are likely to occur. However, the absence of fraud in prior periods is not a reasonable indicator of the likelihood of misstatement due to fraud.

E121. However, the auditor needs to test controls every year, regardless of whether controls have obviously changed. Even if nothing else changed about the company – no changes in the business model, employees, organization, etc. – controls that were effective last year may not be effective this year due to error, complacency, distraction, and other human conditions that result in the inherent limitations in internal control over financial reporting.

E122. What several commenters referred to as "baselining" (especially as it relates to IT controls) is more commonly referred to by auditors as "benchmarking." This type of testing strategy for application controls is not precluded by the standard. However, the Board believes that providing a description of this approach is beyond the scope of this standard. For these reasons, the standard does not address it.

Mandatory Integration with the Audit of the Financial Statements

E123. Section 404(b) of the Act provides that the auditor's attestation of management's assessment of internal control shall not be the subject of a separate engagement. Because the objectives of and work involved in performing both an attestation of management's assessment of internal control over financial reporting and an audit of the financial statements are closely interrelated, the proposed auditing standard introduced an integrated audit of internal control over financial reporting and audit of financial statements.

E124. However, the proposed standard went even further. Because of the potential significance of the information obtained during the audit of the financial statements to the auditor's conclusions about the effectiveness of internal control over financial reporting, the proposed standard stated that the auditor could not audit internal control over financial reporting without also auditing the financial statements. (However, the proposed standard retained the auditor's ability to audit *only* the financial statements, which might be necessary in the case of certain initial public offerings.)

E125. Although the Board solicited specific comment on whether the auditor should be prohibited from performing an audit of internal control over financial reporting without also performing an audit of the financial statements, few commenters focused on the

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significance of the potentially negative evidence that would be obtained during the audit of the financial statements or the implications of this prohibition. Most commenters focused on the wording of Section 404(b), which indicates that the auditor's attestation of management's assessment of internal control over financial reporting shall not be the subject of a separate engagement. Based on this information, most commenters saw the prohibition in the proposed standard as superfluous and benign.

E126. Several commenters recognized the importance of the potentially negative evidence that might be obtained as part of the audit of the financial statements and expressed strong support for requiring that an audit of financial statements be performed to audit internal control over financial reporting.

E127. Others recognized the implications of this prohibition and expressed concern: What if a company wanted or needed an opinion on the effectiveness of internal control over financial reporting as of an interim date? For the most part, these commenters (primarily issuers) objected to the implication that an auditor would have to audit a company's financial statements as of an interim date to enable him or her to audit and report on its internal control over financial reporting as of that same interim date. Other issuers expressed objections related to their desires to engage one auditor to provide an opinion on the effectiveness of internal control over financial reporting and another to audit the financial statements. Others requested clarification about which guidance would apply when other forms of internal control work were requested by companies.

E128. The Board concluded that an auditor should perform an audit of internal control over financial reporting only when he or she has also audited company's financial statements. The auditor *must* audit the financial statements to have a high level of assurance that his or her conclusion on the effectiveness of internal control over financial reporting is correct. Inherent in the reasonable assurance provided by the auditor's opinion on internal control over financial reporting is a responsibility for the auditor to plan and perform his or her work to obtain reasonable assurance that material weaknesses, if they exist, are detected. As previously discussed, this standard states that the identification by the auditor of a *material misstatement* in the financial statements that was not initially identified by the company's internal control over financial reporting, is a strong indicator of a material weakness. Without performing a financial statement audit, the auditor would not have reasonable assurance that he or she had detected all material misstatements. The Board believes that allowing the auditor to audit internal control over financial reporting without also auditing the financial statements would not provide the auditor with a high level of assurance and would mislead investors in terms of the level of assurance obtained.

E129. In response to other concerns, the Board noted that an auditor can report on the effectiveness of internal control over financial reporting using existing AT sec. 501 for purposes other than satisfying the requirements of Section 404. This standard supersedes AT sec. 501 only as it relates to complying with Section 404 of the Act.

E130. Although reporting under the remaining provisions of AT sec. 501 is currently permissible, the Board believes reports issued for public companies under the remaining provisions of AT sec. 501 will be infrequent. In any event, additional rulemaking might be necessary to prevent confusion that might arise from reporting on internal control engagements under two different standards. For example, explanatory language could be added to reports issued under AT sec. 501 to clarify that an audit of financial statements was not performed in conjunction with the attestation on internal control over financial reporting and that such a report is not the report resulting from an audit of internal control over financial reporting performed in conjunction with an audit of the financial statements under this standard. This report modification would alert report readers, particularly if such a report were to appear in an SEC filing or otherwise be made publicly available, that the assurance obtained by the auditor in that engagement is different from the assurance that would have been obtained by the auditor for Section 404 purposes. Another example of the type of change that might be necessary in separate rulemaking to AT sec. 501 would be to supplement the performance directions to be comparable to those in this standard. Auditors should remain alert for additional rulemaking by the Board that affects AT sec. 501.