Grant Thornton LLP
The US Member Firm of
Grant Thornton International

175 West Jackson
Chicago, IL 60604
312 602-8000

Grant Thornton

April 23, 2004

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. 014, *Proposed Auditing Standard – Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2, 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 on the Public Company Accounting Oversight Board's ("Board" or "PCAOB") *Proposed Auditing Standard – Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*. As the Board has adopted PCAOB Auditing Standard No. 2, we support the Board's proposal to amend the PCAOB's interim standards for changes resulting from such adoption. As stated in our previous comment letters, we believe this is critical in order for auditors to be able to fully comply with the PCAOB's auditing and related professional practice standards. It also helps to eliminate potential confusion and inconsistencies in interpretation with respect to the affected portions of the interim standards.

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.

Communications about Control Deficiencies

We concur with the Board's revisions with respect to AU sec. 325, *Communication of Internal Control Related Matters Noted in an Audit*. We recommend, however, that the Board consider providing examples of communications to management and the audit committee regarding internal control deficiencies and communications to the board of directors regarding the audit committee's ineffectiveness. To assist the Board, we have provided potential illustrative communications in Appendices B and C, respectively.

We would be pleased to discuss 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,

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Appendix A – Responses to Questions

1. **Are the references useful in assisting auditors when performing an integrated audit of financial statements and internal control over financial reporting? If not, explain.**

The revisions proposed by the Board to include references in the PCAOB's interim standards to PCAOB Auditing Standard No. 2 are useful. They appropriately direct auditors to the applicable paragraphs within PCAOB Auditing Standard No. 2 when performing an integrated audit of financial statements and internal control over financial reporting. We suggest, however, that the Board consider minimizing such references, where possible. For example, the proposed references to be included in paragraphs 3, 5, and 12 of AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, can be combined into one note. We believe that a note added after each relevant paragraph is not necessary, especially where a particular matter may have been purposely or inadvertently omitted.

With respect to the note to be included after paragraph 1 in AU sec. 313, *Substantive Tests Prior to the Balance-Sheet Date*, we believe the reference to paragraphs 98-103 of PCAOB Auditing Standard No. 2, which discusses the timing of tests of controls, may be confusing, as AU sec. 313 deals with the performance of substantive procedures. A note added after paragraph 5 of AU sec. 313 might be more appropriate. Such note could reference paragraphs 150-156 of PCAOB Auditing Standard No. 2, which discuss tests of controls in an audit of financial statements and the effect of such tests on substantive procedures. If deemed necessary, it could then reference paragraphs 98-103 of PCAOB Auditing Standard No. 2.

2. **Have any references been omitted from the proposed auditing standard that commenters believe would be beneficial? If so, explain.**

Paragraph 192 of PCAOB Auditing Standard No. 2 addresses the auditor's procedures when management includes additional information regarding internal control outside of its report on internal control over financial reporting but within its annual report on the entity's financial statements. We believe a reference to this paragraph within AU Sec. 550, *Other Information in Documents Containing Audited Financial Statements*, would be appropriate.

3. **Do the proposed amendments clearly describe the new requirements that apply when the auditor is engaged to audit only the financial statements? If not, how can the Board more clearly describe the new requirements?**

Except as noted herein and in our letter, we believe the proposed amendments clearly describe the new requirements.

4. **Are there any additional requirements that are applicable in an integrated audit of financial statements and internal control over financial reporting that also should be applicable when the auditor is engaged to audit only the financial statements?**

Paragraph 18 of AU sec. 324, *Service Organizations*, requires the auditor to make inquiries concerning the service auditor's professional reputation when considering whether the service auditor's report is satisfactory for his or her purposes. Paragraph B24 of PCAOB Auditing Standard No. 2 requires the auditor to make inquiries regarding the service auditor's competence and independence, in addition to their reputation, when determining whether the service auditor's report provides sufficient evidence to support management's assessment and the auditor's opinion. As we cannot determine why such inquiries would differ for a financial statement audit versus an integrated audit of financial statements and internal control over financial reporting, we suggest amending AU sec. 324 to require the auditor to also inquire as to the service auditor's competence and independence when only performing a financial statement audit.

For Example:

- Should the auditor be required to report all internal control deficiencies (i.e., including internal control deficiencies that are less severe than significant deficiencies and material weaknesses) to management not previously communicated in writing by the auditor or by others? (Under the proposed amendment, the auditor would be required to report to management and the audit committee significant deficiencies and material weaknesses identified during the audit.)

  For a financial statement audit, 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.

- Should the auditor evaluate the effectiveness of the audit committee's oversight of the external financial reporting process and the internal control over financial reporting? (Under the proposed amendment, the auditor does not have an explicit requirement to make this evaluation but would be required to report in writing to the board of directors a conclusion that the audit committee's oversight is ineffective, even if the auditor did not perform an evaluation to reach that conclusion.)

  For a financial statement audit, we do not believe that the auditor should be required to separately evaluate the effectiveness of the audit committee's oversight of the external financial reporting process and internal control over financial reporting. However, because the audit committee "…plays an important role within the control environment and monitoring components of internal control over financial reporting," we believe the auditor should be required to obtain an understanding of the audit committee's oversight. To the extent (a) such controls would be relevant, individually or in combination with others, in preventing or detecting material misstatements in financial statement assertions and (b) the auditor places reliance on such controls, additional procedures to evaluate the effectiveness of the audit committee would be performed.

5. Are there any circumstances in which the proposed amendments in an audit of financial statements are not appropriate or should not be made? If so, what are those circumstances, and why do they indicate that the proposed amendment is not appropriate? Recognizing that the requirements in the proposed amendments are required in an integrated audit, describe the circumstances that are different in an audit of financial statements from those in an integrated audit of financial statements and internal control over financial reporting.

The proposed amendment (paragraph 2. e.) for AU sec 310, *Appointment of the Independent Auditor,* states that in an integrated audit, we plan and perform the audit to obtain reasonable assurance about whether the entity maintained, in all material respects, effective internal control. It also states that the auditor is responsible for obtaining an understanding of internal control sufficient to plan the financial statement audit. We believe such statements in an engagement letter could be potentially confusing, as they indirectly imply that a separate and distinct understanding of internal control is obtained for both audits. It may be appropriate to add the concepts discussed in paragraph 146 of PCAOB Auditing Standard No. 2, which address how such understanding is interrelated.

In addition, we suggest that the Board thoroughly review the interim standards to determine whether any other references to "assertions" should be replaced by the term "relevant assertions."

6. Are there any circumstances in which issuers would want or need to file an AT sec. 501 report with the Commission? If so, explain.

We cannot identify any circumstance where the Securities and Exchange Commission ("Commission") would require or even permit an issuer to file an AT sec. 501 report. Accordingly, we do not believe issuers would want or need to file such a report with the Commission. Refer to our response to Question No. 8.

7. Should AT sec. 501 be amended rather than superseded? If amended, what types of changes should be made to AT sec. 501?

We believe that PCAOB Auditing Standard No. 2 set the bar for performing an audit (or examination) of the effectiveness of an entity's internal control over financial reporting. Accordingly, if the Board were to amend AT sec. 501, it should be closely aligned with PCAOB Auditing Standard No. 2. Otherwise, there will be different standards for the two engagements, which would not be in the public interest.

On the other hand, AT sec. 501 could be amended to provide a lower level of assurance, such as that provided by a review of interim financial information. However, the need for such a report ought to be evaluated. Refer to our response to Question No. 8

8. Is there a need for an auditor's report on internal control in addition to the auditor's report on the integrated audit of financial statements and internal control over financial reporting? If so, what information should the report include? In which circumstances would the report be issued? Who would use the report?

We believe the goal of professional standards to be inclusive, rather than proscriptive. Accordingly, although we may not be aware of the circumstances in which such audit reports would be requested, we do believe that once the world understands these engagements, there might come requests from different places. Refer to our response to Questions No. 6 and 7.

Appendix B – Illustrative Communication of Internal Control Related Matters to Management and the Audit Committee

Audit Committee and Management
ABC Corporation

In planning and performing our audit of the financial statements of ABC Corporation for the year ended December 31, 20XX, we considered ABC Corporation's internal control over financial reporting in order to determine our audit procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on internal control. Accordingly, our consideration of internal control would not necessarily disclose all deficiencies in internal control over financial reporting that might be significant deficiencies [*or material weaknesses*]. However, as discussed below, we noted certain deficiencies involving internal control that we consider to be significant deficiencies [*and material weaknesses*] under the standards of the Public Company Accounting Oversight Board (United States).

Or

In planning and performing our audit of the effectiveness of ABC Corporation's internal control over financial reporting as of December 31, 20XX, 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)"*)], we considered internal control to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Accordingly, we were not required to perform procedures sufficient to identify all deficiencies involving internal control. However, as discussed below, we noted control deficiencies that we consider to be of a lesser magnitude than significant deficiencies and control deficiencies that we consider to be significant deficiencies [*and material weaknesses*] under the standards of the Public Company Oversight Board (United States).

Continue with the following:

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 significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects a 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 entity'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 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. We believe that the following significant deficiencies constitute material weaknesses under the standards of the Public Company Accounting Oversight Board (United States). (Include paragraphs to describe the material weaknesses noted and their effect on the achievement of the objectives of the control criteria.)*]

We [*further*] consider the following control deficiencies to be significant deficiencies in internal control over financial reporting. *(Include paragraphs to describe the significant deficiencies noted.)*

[*In addition*,] We consider the following matters to be of a lesser magnitude than significant deficiencies. *(Include paragraphs to describe the internal control deficiencies noted.)*

[*We recommend that ABC Corporation consider the following actions: (Include a description of the actions the company may consider.)]*

This report is intended solely for the information and use of the audit committee [*board of directors, board of trustees*], management, and others within the organization [*and specified regulatory agency*] and is not intended to be and should not be used by anyone other than these specified parties.

Signature

City and State or Country

Date

Appendix C – Illustrative Letter to Board of Directors on Audit Committee Ineffectiveness

Board of Directors
ABC Corporation

In planning and performing our audit of the effectiveness of ABC Corporation's internal control over financial reporting as of December 31, 20XX, 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)"*)], we considered internal control to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included, among other things, an assessment of the effectiveness of the audit committee's oversight of ABC Corporation's external financial reporting and internal control over financial reporting. Such assessment was performed as part of our understanding of the control environment and monitoring components of internal control and not for the purpose of performing a separate and distinct evaluation of the audit committee.

Or

In planning and performing our audit of the financial statements of ABC Corporation for the year ended December 31, 20XX, we considered ABC Corporation's internal control over financial reporting in order to determine our audit procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on internal control. Accordingly, we were not required to perform an assessment of the effectiveness of the audit committee's oversight of ABC Corporation's external financial reporting and internal control over financial reporting. However, as discussed below, we noted a control deficiency relating to the audit committee's oversight that we consider to be a significant deficiency [*or material weakness*] under the standards of the Public Company Oversight Board (United States).

Continue with the following:

An 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 a company's activities in the financial arena. The aspects of an audit committee's effectiveness that are important may vary considerably with the circumstances. Accordingly, a company's board of directors is responsible for evaluating the performance and effectiveness of the audit committee.

We noted a control deficiency relating to the audit committee's oversight of ABC Corporation's external financial reporting and internal control over financial reporting that we consider to be a significant deficiency [*or material weakness*] under the standards of the Public Company Oversight Board (United States). 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 significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects a 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 entity'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 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.*]

We believe that the following [*control deficiency is a significant deficiency in internal control over financial reporting* ***or*** *significant deficiency constitutes a material weakness*] under the standards of the Public Company Accounting Oversight Board (United States). (*Include paragraphs to describe the significant deficiency or material weakness noted, including the effect on the achievement of the objectives of the control criteria.*)

[*We recommend that ABC Corporation and the Board of Directors consider the following actions: (Include a description of the actions the company may consider.)*]

This report is intended solely for the information and use of the [*board of directors, board of trustees*], audit committee, management, and others within the organization [*and specified regulatory agency*] and is not intended to be and should not be used by anyone other than these specified parties.

Signature

City and State or Country

Date