



280 Park Avenue
New York, N.Y. 10017
8th Floor

Telephone 212-909-5600
Fax 212-909-5699

April 23, 2004

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

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 Mr. Secretary:

We appreciate this opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or Board) 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* (Proposed Standard). We recognize and acknowledge the efforts of the PCAOB staff to identify timely the conforming amendments to the Board's interim standards resulting from the Board's adoption of PCAOB Auditing Standard No. 2.

We agree with the Board that its proposed standards should identify how they affect existing standards and commend the Board for its commitment to include, in future standard-setting proposals, specific identification of related proposed amendments to other standards. Identification of such changes is essential to enabling auditors to comply with the Board's standards.

This letter is organized by first providing general observations and comments on the Proposed Standard followed by responses to the specific questions posed in PCAOB Release No. 2004-02. Less significant and editorial comments and suggestions are included in Appendix A to this letter.





General Observations and Comments

Amendment to AU Section 310, “Appointment of the Independent Auditor”

Paragraph 2e of the Proposed Standard sets forth a proposed amendment to the eighth bullet point of AU Section 310.06. This proposed amendment sets forth a requirement for the auditor to communicate to the board of directors any significant deficiency or material weakness identified due to the audit committee’s ineffective oversight of the company’s external financial reporting and internal control over financial reporting. Pursuant to the provisions of PCAOB Auditing Standard No. 2, we recognize that the auditor should assess the effectiveness of the audit committee as part of understanding and evaluating the control environment and monitoring components of internal control in an integrated audit. Because of the differing objectives in an integrated audit and an audit of financial statements, we recommend that the Board clarify that this communication requirement is required in those instances when an audit of internal control is not performed. Accordingly, we suggest that the amendment to the eighth bullet point of paragraph 310.06, under the sub-bullet “Audit of financial statements,” be modified as follows:

To the board of directors – any specific significant deficiency or material weakness identified because the auditor concludes that the audit committee’s oversight of the company’s external financial reporting and internal control over financial reporting is ineffective, even if the auditor did not perform an evaluation or otherwise perform procedures to reach that conclusion.

Amendment to AU Section 325, “Communication of Internal Control Related Matters Noted in an Audit”

Paragraph 10 of the Proposed Standard sets forth a proposed replacement of AU Section 325. Paragraph 5 of the proposed replacement of AU Section 325 indicates that there is not an *explicit* requirement for the auditor to evaluate the effectiveness of the audit committee. This language implies that there may be an *implicit* requirement. For clarification, we recommend that the word *explicit* be removed.

In addition, paragraph 5 of the proposed replacement of AU Section 325 sets forth an auditor communication requirement when a significant deficiency or material weakness relating to ineffective oversight by the audit committee *exists*. Consistent with the notion that the auditor is not responsible for performing a separate and distinct evaluation of the audit committee, we suggest that the Board clarify that this communication requirement applies when such a significant deficiency or material weakness *is identified*, and recommend that the proposed replacement be revised accordingly.



Office of the Secretary
Public Company Accounting Oversight Board
April 23, 2004
Page 3

Our recommendations for modifying paragraph 5 of the proposed replacement of AU Section 325 are as follows:

Although there is not ~~an explicit~~ a requirement to ~~evaluate~~ perform a separate and distinct evaluation of the effectiveness of the audit committee's oversight of the external financial reporting process and the internal control over financial reporting, if the auditor identifies 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.

Paragraph 6 of the proposed replacement of AU Section 325 indicates that the auditor's written communications to management and the audit committee should include, among other things, the definitions of control deficiencies, significant deficiencies and material weaknesses. Because paragraph 4 of the proposed replacement requires the auditor to communicate in writing only significant deficiencies and material weaknesses, we recommend that the required communication of definitions in paragraph 6 omit the definition of control deficiencies.

Paragraph 7 of the proposed replacement of AU Section 325 states, "When there are requirements established by governmental authorities to furnish such reports, specific reference to such regulatory authorities may be made." We recommend that "such reports" be changed to "such written communications" for consistency with the remainder of the proposed replacement. In addition, we recommend that paragraph 7 be included in paragraph 6c to give this particular communication proper context.

To promote consistency of auditors' communications, we recommend that the replacement for AU Section 325 include an illustrative written communication, similar to that in existing AU Section 325.

Paragraph 11 of the Proposed Standard indicates that, "auditors may continue to apply auditing interpretation 1 to AU Section 325, 'Reporting on the Existence of Material Weaknesses,' except that the term 'reportable condition' means [and presumably should be changed to] 'significant deficiency'" Since the Proposed Standard would supersede AU Section 325 in its entirety and replace it with a rewritten version, we recommend that the interpretation, revised as necessary to reflect terminology adopted by the Board, be incorporated into the replacement for AU Section 325.



Responses to Individual Questions

Our responses to the questions outlined in PCAOB Release No. 2004-02 follow:

Questions regarding the addition of references

- 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.**

Yes. We believe the references are useful, and in fact are essential, to auditors when performing an integrated audit of financial statements and internal control over financial reporting.

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

Footnote 1 to AU Section 380, "Communication with Audit Committees," lists standards that have audit committee communication requirements in addition to the requirements in AU Section 380. We suggest that PCAOB Auditing Standard No. 2 be added to this footnote.

Questions regarding amendments applicable to both integrated audits of financial statements and internal control over financial reporting and audits of financial statements

- 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 for our observations and recommendations elsewhere in this letter, we believe the proposed amendments clearly describe the new requirements that apply when an auditor is engaged to audit only the financial statements.

- 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? 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.)

- **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.)**

We are not aware of 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. Our view includes the examples provided regarding reporting of all internal control deficiencies and evaluating the effectiveness of the audit committee's oversight; thus, we do not believe that these concepts should be extended to situations in which the auditor is engaged to audit only a company's financial statements.

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.**

We do not believe there are circumstances in which the proposed amendments are not appropriate in an audit of financial statements.

Questions regarding attestation standards

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 believe that this question should be specifically addressed to the Commission. Conceivably, there could be instances where the Commission may require an issuer to file an auditors' report on internal control as of a date other than the



Office of the Secretary
Public Company Accounting Oversight Board
April 23, 2004
Page 6

issuer's fiscal year-end. This alternative is not provided for in PCAOB Auditing Standard No. 2. We are not aware of any circumstances in which an issuer would want to file an AT Section 501 report with the Commission.

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 AT Section 501 should be superseded. Because of the differences in auditor performance requirements between PCAOB Auditing Standard No. 2 and AT Section 501, preserving AT Section 501 would likely create confusion among users of auditors' reports on internal control over financial reporting. Accordingly, we believe there should be only one such standard for audits of issuers' internal control over financial reporting.

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 agree with the Board's conclusions, as expressed in Appendix E of PCAOB Auditing Standard No. 2, that the objectives of, and work involved in performing, an audit of internal control over financial reporting and an audit of financial statements are so closely related that an auditor should not audit a company's internal control over financial reporting without also auditing the company's financial statements. Accordingly, we do not believe an auditor should express an opinion on the effectiveness of an issuer's internal control over financial reporting without also auditing the issuer's financial statements.

* * * * *

Questions regarding information included in this letter should be directed to 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. Amendment to AU Section 311, “Planning and Supervision”

Paragraph 3 of the Proposed Standard sets forth a proposed note that would follow AU Section 311.01. The note directs a reader to refer to PCAOB Auditing Standard No. 2 when performing an integrated audit. To clarify that the planning considerations in PCAOB Auditing Standard No. 2 are incremental to, rather than in place of, the planning considerations set forth in AU Section 311, we recommend that the proposed note be modified as set forth below. Also, the word “Auditing” should be included in the reference to PCAOB Auditing Standard No. 2 for consistency.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 39 of PCAOB Auditing Standard No. 2 regarding planning considerations, in addition to the planning considerations set forth in this section.

2. Amendment to AU Section 312, “Audit Risk and Materiality in Conducting an Audit”

Paragraph 4b of the Proposed Standard sets forth a proposed note that would follow AU Section 312.05, and would direct a reader to refer to paragraphs 24-26 of PCAOB Auditing Standard No. 2 regarding fraud considerations. AU Section 312.05 discusses the concept of materiality, whereas AU Section 312.07 includes a more substantive explanation of the term *fraud*. We recommend that the note proposed in paragraph 4b of the Proposed Standard be placed following AU Section 312.07.

Paragraph 4d of the Proposed Standard sets forth a proposed note that would follow AU Section 312.18, and would direct a reader to Appendix B of PCAOB Auditing Standard No. 2, “for discussion of tests to be performed when a company has multiple locations or business units.” We believe the precise purpose of the reference is unclear; one could inappropriately infer from the reference that an auditor in an integrated audit should look to Appendix B for guidance on substantive testing as well as internal control testing. We recommend that the reference be clarified by replacing the language quoted above with “for discussion of tests of controls to be performed when a company has multiple locations or business units” or with “for considerations when a company has multiple locations or business units.”

3. Amendment to AU Section 316, “Consideration of Fraud in a Financial Statement Audit”

Paragraph 6 of the Proposed Standard sets forth a proposed note that would follow AU Section 316.01, and would direct a reader to refer to paragraphs 24-26 of PCAOB Auditing Standard No. 2 regarding fraud considerations. To clarify that the fraud considerations in PCAOB Auditing Standard No. 2 are incremental to, rather than in

place of, the fraud considerations set forth in AU Section 316, we recommend that the note be modified as follows:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 39 of PCAOB Auditing Standard No. 2 regarding fraud considerations, in addition to the fraud considerations set forth in this section.

4. Amendment to AU Section 319, “Consideration of Internal Control in a Financial Statement Audit”

Paragraph 7d of the Proposed Standard sets forth a proposed note that would follow AU Section 319.09, and would direct a reader to Appendix B of PCAOB Auditing Standard No. 2 “for discussion of tests to be performed when a company has multiple locations or business units.” Please refer to our comment 2 above regarding the same language proposed to be added after AU Section 312.18.

AU Section 319.83 requires that the auditor document the basis for his or her conclusion when assessing the level of control risk at less than the maximum. Paragraph 7f of the Proposed Standard sets forth a proposed note that would follow AU Section 319.83, and would incorporate the requirement in PCAOB Auditing Standard No. 2 that the auditor document the basis for his or her conclusion when assessing the level of control risk as other than low. To add clarity by avoiding an apparent contradiction between existing AU Section 319.83 and the proposed amendment to the same paragraph, we recommend that the proposed note be modified as follows:

Note: ~~In an integrated audit of financial statements and internal control over financial reporting,~~ PCAOB Auditing Standard No. 2, paragraph 160, states, in part, ~~that~~ “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.” Accordingly, in an integrated audit of financial statements and internal control over financial reporting, if control risk is assessed at the maximum level, the auditors should document the basis for that conclusion regardless of whether control risk is assessed at or below the maximum. Refer to paragraphs 159-161 of PCAOB Auditing Standard No. 2 for additional information regarding documentation requirements in an integrated audit of financial statements and internal control over financial reporting.

5. Amendment to AU Section 324, “Service Organizations”

Paragraph 9 of the Proposed Standard sets forth a proposed note that would follow AU Section 324.01, and would direct a reader to refer to paragraphs B18-B29 of Appendix B, “Additional Performance Requirements and Directions; Extent-of-

Testing Examples,” in PCAOB Auditing Standard No. 2 regarding the use of service organizations. To clarify that the considerations regarding the use of service organizations in PCAOB Auditing Standard No. 2 are incremental to, rather than in place of, such considerations set forth in AU Section 324, we recommend that the note be modified as follows:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs B18-B29 of Appendix B, “Additional Performance Requirements and Directions; Extent-of-Testing Examples,” of PCAOB Auditing Standard No. 2 regarding the use of service organizations, in addition to the considerations set forth in this section.

6. Amendment to AU Section 332, “Auditing Derivative Instruments, Hedging Activities, and Investments in Securities”

Paragraph 14 of the Proposed Standard sets forth a proposed note that would follow AU Section 332.11, and would state that in an integrated audit, if a company’s investment in derivatives and securities represents a significant account, the auditor’s understanding of controls should include controls over derivatives. The purpose of this note is unclear, as the guidance provided is self-evident, and similar guidance is not proposed to be added to auditing standards on auditing inventories, for example. We recommend that the proposed note be omitted for purposes of clarity.

7. Amendment to AU Section 333, “Management Representations”

Paragraph 15 of the Proposed Standard sets forth a proposed note that would follow AU Section 333.05, and would direct a reader to refer to paragraphs 142-144 of PCAOB Auditing Standard No. 2 for required representations to be obtained from management. To clarify that the management representations in PCAOB Auditing Standard No. 2 are incremental to, rather than in place of, the written representations set forth in AU Section 333, we recommend that the note be modified as follows:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 142-144 of PCAOB Auditing Standard No. 2 for additional required written representations to be obtained from management.

8. Amendment to AU Section 508, “Reports on Audited Financial Statements”

Paragraph 18b of the Proposed Standard would add, to AU Section 508.08, a subparagraph k, which would include an illustrative paragraph to be used in the audit report on the financial statements when an auditor performs an integrated audit and issues separate reports on the financial statements and on internal control over financial reporting. For consistency with the remainder of AU Section 508.08, we

recommend that subparagraph k describe the subject element of the report and that the illustrative report paragraph be moved to the body of each of the two illustrative reports at the end of paragraph 8. We also recommend that the new subparagraph be placed before existing subparagraph i (and the remaining subparagraphs be relettered) in order to maintain the basic elements of the report in the order in which they generally will appear in an auditors' report.

In addition, for consistency with the existing examples, the reference to "W Company" in the proposed illustrative paragraph should be changed to "X Company" or "the Company."

9. Amendment to AU Section 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"

We recommend the following editorial revision to the note proposed to be added to AU Section 561.01:

Note: When an auditor has performed ~~performing~~ an integrated audit of financial statements and internal control over financial reporting and subsequent to the date of the auditor's report(s) becomes aware of facts of the nature described in paragraph .01 above, refer to paragraph 197 of PCAOB Auditing Standard No. 2, which provides direction with respect to subsequent discovery of information existing at the date of the auditor's report on internal control over financial reporting.

10. Amendment to AU Section 711, "Filings Under Federal Securities Statutes"

We recommend the following editorial revision to the note proposed to be added to AU Section 711.02:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 198-199 of PCAOB Auditing Standard No. 2, which provide direction when an auditor's report on internal control over financial reporting is included or incorporated by reference in ~~with respect to~~ filings under federal securities statutes ~~in an audit of internal control over financial reporting.~~

11. Superseding AT Section 501, "Reporting on an Entity's Internal Control over Financial Reporting"

Paragraph 25 of the Proposed Standard indicates that AT Section 501 is intended to be superseded. We presume that Interpretation 1 to AT Section 501, "Pre-Award Surveys," also is intended to be superseded. We recommend that this point be clarified in the final standard.

* * * * *