

May 12, 2003

Office of the Secretary
Attention: Mr. Gordon Seymour
Acting General Counsel
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Reference: PCAOB Release No. 2003-005, dated April 18, 2003: *Statement Regarding the Establishment of Auditing and Other Professional Standards*

Dear Mr. Seymour:

The Institute of Internal Auditors (IIA) applauds the commencement of operations of the Public Company Accounting Oversight Board (PCAOB). The formation of the board, with the appointment of Mr. William J. McDonough as board chairman and the selection of Mr. Douglas R. Carmichael as chief auditor, are key steps in launching the new standard-setting board.

The IIA is pleased to have this opportunity to comment on one of the PCAOB's initial statements, Release No. 2003-005 on the *Establishment of Auditing and Other Professional Standards*. The IIA endorses the PCAOB's methodology for developing an open process for adopting and amending Professional Auditing Standards and in expressing its intent to create a standing advisory group and use other groups and ad hoc task forces in the development of new or amended standards. In addition, the PCAOB's intent to conduct a step-by-step review of the existing standards, which were promulgated by other bodies and currently classified as "Interim Professional Auditing Standards", is a practical and appropriate measure.

Also, we concur with the release's statement that the PCAOB will review both the existing standards and the AICPA's March 18th proposals for amending and adding auditing standards on the external auditor's duties in attesting to the report on a public company's internal controls over financial reporting. The IIA recently provided comments to the AICPA on those exposure draft proposals, a copy of which is attached for your information.

Our Commitment

The IIA can provide the PCAOB and its standing advisory group with specialized knowledge and understanding about the risk exposures and control measures surrounding the preparation of corporate financial reports. We are committed to providing leaders from the internal auditing profession to serve as members of the standing advisory group and as participants at PCAOB-sponsored roundtables and developmental task forces, as appropriate.

The IIA and the Role of Internal Auditors

The IIA looks forward to working with the board's advisory group, task forces, and staff as they work to establish and maintain auditing and related standards that support the integrity and professionalism of the auditors. The IIA is a professional association serving more than 85,000 internal auditors from 140 countries, and its global headquarters is located in Altamonte Springs, Florida. We represent an important constituency within the public company auditing and governance disciplines, and can provide to the PCAOB the profession's leading thinkers and internal auditing executives to serve on your advisory groups and task forces.

The IIA possesses expertise developed over many years in the auditing of risk management, control, and governance processes of organizations. It has sponsored research and created educational materials on enterprise risk management evaluations, control models and assessment strategies, and the best practices of corporate boards and their audit committees. The IIA has worked with the National Association of Corporate Directors (NACD) on its "Blue Ribbon Commission" recommendations to improve corporate boards and audit committees. The IIA, as a founding member, has partnered with the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in conducting the highly credible study titled *Internal Control – Integrated Framework (1992 and 1994)* and the soon-to-be-released Enterprise Risk Management Framework project (expected later this year).

Internal auditors provide essential assurance services to their organizations, especially in testing and evaluating the soundness and effectiveness of internal control processes. Various components of the enterprise's internal control system, when operating properly, provide assurance to management, the audit committee, and board that the accounting statements and accompanying financial and business information are reliable. A significant portion of the annual work plan of an internal audit function is allocated to assessing the company's risk management and control processes, and that plan is coordinated with the audit plan of the external auditor and approved by the audit committee.

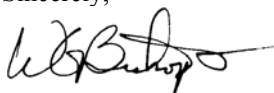
An internal audit function of an entity is independent of management. Its charter and policies are approved by the company's audit committee. The charter and policies ensure that the internal auditors will have full access to senior management, audit committee, and board, with unrestricted access to the company's records, personnel, and properties. The chief internal audit executive functionally reports to the entity's audit committee. The internal auditors perform their work in accordance with The IIA's *Standards for the Professional Practice of Internal Auditing* and *Code of Ethics*. (The *Standards* and *Code of Ethics* have been translated into 20 languages.) The work of the internal audit function is subject to periodic quality assessments.

Conclusion

The board and staff members are embarking on an important venture that will have a significant effect on the public's ultimate trust in corporate reports. Both external and internal auditors play vital roles in support of the legal and professional responsibilities of management executives, audit committees, and boards for ensuring that their companies provide truthful, informative corporate reports.

We look forward to working with the PCAOB and are committed to providing internal audit leaders to serve on its advisory group, task forces and roundtables, as appropriate.

Sincerely,



William G. Bishop III, Certified Internal Auditor

Attachment – Comments Provided to the AICPA

cc: Mr. Charles Landes, AICPA

May 12, 2003

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Director, Audit and Attest Standards
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Dear Mr. Landes:

The Institute of Internal Auditors (IIA) agrees that the auditing practices for reporting on the adequacy and effectiveness of an organization's internal controls over financial reporting should be updated to fit with the new laws and regulations. Further, The IIA recognizes the sizeable investment of people and time by the AICPA's Auditing Standards Board and its task force in developing the four exposure drafts of new and amended standards. As the principle voice of the internal auditing profession, The IIA offers unique insights about the complex issues of assessing internal control processes and utilizing the work of internal auditors by external practitioners.

The IIA agrees with the broad tenets of the proposed auditing standards. They are generally consistent with the IIA's professional guidance relating to risk management and control. However, several positions taken in the proposed statements are troublesome, and some issues relating to the assessment process lack adequate guidance. The IIA believes that the proposed amended Statement on Standards for Attestation Engagement (SSAE), entitled *Reporting on an Entity's Internal Control Over Financial Reporting*, and the proposed new Statement on Auditing Standards (SAS), entitled *Auditing and Entity's Internal Control Over Financial Reporting in Conjunction with the Financial Statement Audit*, are deficient and should be enhanced. Our concerns are summarized below and then explained more fully thereafter.

1. The way in which the work performed by internal auditors is presented in the exposure draft is confusing and contradictory. Paragraph 51 identifies the unique role of internal auditors in performing tests on the organization's controls. However, paragraphs 74-76 discuss the use of the tests of "responsible parties" and make the tests and assessments conducted by internal audit indistinguishable from that of management personnel and third parties. The result is that many organizations and practitioners question whether the external auditors can put reliance on the work of internal auditors. The IIA believes that the SSAE should be amended to give greater importance and priority to the work of internal auditors, particularly their normally extensive assessments of the entity's internal controls. The substantial evidence provided by an independent, well managed, and competent internal audit function that performs its activities by the highest professional standards will provide the external auditor with an invaluable understanding of the entity's risk management and control procedures and their effectiveness. In most circumstances, internal audit work on control processes should have greater credibility and higher reliability for the external auditor than other sources of evidence about an organization's internal control system. In addition, the new SAS should contain similar guidance on reliance on the work of the internal auditors that is encompassed in SAS No. 65 (AU §322).

Mr. Charles Landes
May 2003
Page Two

2. Practical guidance is lacking on attributes of a “significant deficiency” and “material weakness” and the factors to consider in aggregating and mitigating deficiencies. Clarity of the terms and their practical application are essential if the assessment of the organization’s management, work of internal auditors, and attestation by the external practitioner are to be based on mutually acceptable principles.
3. Practical guidance is also essential if the proposed standard is to retain the position that inadequate documentation of the “design” of internal controls may constitute a significant deficiency. The standard must be accompanied by specific criteria for evaluating the design of internal controls and the attributes of proper documentation.

The following section explains more fully our positions.

1. Emphasize that testing by internal auditors can be relied on by the external auditors.

The proposed SSAE in paragraph 74 classifies work performed by internal auditors as one source on which senior management bases its assertion about the effectiveness of internal control. This paragraph makes the internal audit function’s work indistinguishable from the evaluations and tests performed by management and third parties. Some auditors—both internal and external—have read the proposed rules and concluded that the guidance will encourage the external auditors to undervalue the competencies and work quality of internal auditors and to fail to assimilate their considerable knowledge and understanding of the organization’s internal controls. The apparent interpretation of the proposed rules is that the work of the internal audit function has no more value and relevance to the external auditor than any other management group or third party. External auditors will pass over the internal audit function’s accumulated assessments of the enterprise’s internal control processes and re-perform a vast amount of testing.

The IIA believes that interpretation of the proposed rules will lead external audit practitioners to conduct unnecessary and poorly designed tests by failing to study the considerable work of the internal auditors. An important mission of the internal audit function is the testing and assessment of an organization’s risk management and control processes. An internal audit function is a unique organizational unit of an entity; it is independent of management responsibilities and performs objective assessments. The internal audit function and its chief audit executive typically report to the audit committee and have a charter ensuring that the function has full and unrestricted access to records, property, and personnel of the enterprise and may pursue its work plan without management interference.

We strongly recommend that in paragraph 74 of the amended SSAE, the reference to “internal audit” be omitted. Instead, we would add a sentence to the paragraph to state the following: *The use of the work of internal audit function is discussed in paragraph 51 and in the Statement of Auditing Standards No. 65, entitled The Auditor’s Consideration of the Internal Audit Function in an Audit of Financial Statements (AU §322). This will treat the work of internal auditors as a special class of available evidence about the organization’s internal controls. That special status was implicit in the AICPA’s Statement of Auditing Standards No. 65. That standard says that the external auditor should sufficiently review the work of the internal audit function “to identify those internal audit activities that are relevant to planning the audit.”*

Relevant activities are defined later in the standard as evidence about the design and effectiveness of controls. Using the tests and assessments performed by internal auditors and the information gained about the internal control system will greatly enhance the external auditor's understanding of the adequacy and effectiveness of the system and enable them to design and perform only the needed tests to clarify or resolve significant control issues. The resulting effect would also be lower external audit fees incurred by organizations.

The IIA also believes that the proposed SAS, entitled *Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit*, is generally consistent with the guidance recommended in the proposed SSAE. However, it fails to acknowledge the work of the internal audit function, management, and third parties in providing evidence about the effectiveness of the organization's internal controls over financial reporting, and it does not provide guidance on how that work may influence the testing of controls by the external practitioner. This standard should contain a reference to SAS No 65 (AU §322).

The IIA also requests modification of the final sentence in paragraph 51. It is inappropriate to say: "...the practitioner should recognize that a potential impairment of objectivity may exist when internal auditors perform a monitoring function within the entity's internal control." IIA guidance recommends that internal auditors evaluate the systems of internal control and provide the assessments to management and the audit committee. The results of those engagements are reported to management who retain the responsibility for the adequacy and effectiveness of the internal controls. This evaluation activity by the internal auditors does not impair the objectivity of internal auditors. We recommend that the assertion in paragraph 51 be deleted.

Engagements of internal auditors are conducted in accordance with the globally recognized IIA *Standards for the Professional Practice of Internal Auditing*. Adherence with the *Standards* and *Code of Ethics* is required by all individuals who provide internal audit services. Those Standards (which have been translated into 20 languages) ensure that internal audit work is performed by competent professionals and complies with professional standards and rules of conduct requiring objectivity, due professional care, and periodic quality assessments.

The work plans of the internal auditors and external auditors are normally jointly planned and coordinated, approved by the audit committee, and information about the system of controls and audit findings shared among the audit groups. As a result, duplication of work is avoided and redundant procedures are replaced by more effective and focused tests. Some work performed by the internal and external auditors may be similar in nature dealing with the same or similar processes, but under most circumstances, the work of the internal auditor should be relied upon by the external auditor. The result is that the degree of assurance is not diminished, but the quantity of audit work by the external auditor is reduced and more effective.

If the work of the internal audit function is to be given special credence in the external auditor's assessment of an organization's internal control process, the proposed SSAE should provide examples of ways to encourage the exchange of work between the two audit groups. That coordination should include review of the work plans for the coming year and the scheduling of engagements, access to engagement files and reports of audit findings, sharing of significant audit issues, observed deficiencies and follow-up actions, and regular face-to-face meetings.

We understand the need for external auditors to test the work of internal auditors to ascertain that the work was conducted in accordance with the IIA's *Standards for the Professional Practice of Internal Auditing*, that internal auditors are competent and properly supervised, and the audit function is organizational independent of management's responsibilities and free of interference from the entity's personnel. Internal auditors typically have unrestricted access to management and the board and to the records, personnel, and properties of the organization. If the external auditor obtained those assurances, the work of the internal auditors should be considered as possessing more credibility than the work of other management personnel for the purposes of this attestation engagement.

2. Expand guidance for applying “significant deficiencies” and “material weaknesses”

The guidance in the proposed statements related to significant deficiencies and material weaknesses is useful. However, as pointed out in COSO's *Internal Control – Integrated Framework Executive Summary*, “[I]nternal control means different things to different people. This causes confusion among businesspeople, legislators, regulators and others.” We believe that confusion about the definition and its application still reigns in management, among internal auditors, and in the positions of accounting firms and their partners.

We believe organizations, external auditors, and internal auditors would benefit with the addition of more guidance on what is a significant deficiency, what is a material weakness and how an aggregation of significant deficiencies could aggregate to a material weakness. We believe that additional guidance would help an organization's executive management, internal auditors, external auditors, and audit committees make more consistent decisions.

However, The IIA believes that there are limits to setting detailed definitions and rules that would be applicable to all public companies. The proposed auditing standards should encourage the practitioner to discuss with the audit committee, senior management, and internal audit executive the appropriate definitions of significant deficiency and material weakness for the company and the ways those terms will be applied by both groups of auditors and management. Those discussions should be convened when the audit plans of the external and internal auditors for the coming fiscal year are being reviewed.

3. Provide guidance on what constitutes adequate documentation of the design of controls

The IIA agrees with the premise in paragraphs 15, 16, and 52 that management should identify the controls designed to prevent material misstatements of significant classes of transactions, account balances, and disclosures. We agree that documentation of those controls provides a tool for training and monitoring the effectiveness of the significant internal controls.

Mr. Charles Landes
May 2003
Page Five

However, we believe it is inappropriate to state in paragraph 16 that “[I]nadequate documentation of the design of controls may result in a significant deficiency or a material weakness...” While some perceived failures in possessing sufficient documentation may constitute a deficiency, it also may not be substantive proof of a deficiency because the forms of documentation are infinite (paragraph 52 lists some examples) and the evidence of control may reside in the entity’s existing culture and common business practices. We suggest modifying the fourth sentence of paragraph 16 to read: “Inadequate documentation of the design of controls *of significant processes, accounts, or groups of accounts* may result in a significant deficiency or a material weakness and may constitute a limitation on the scope of the engagement, *unless alternative forms of evidence or applied business practices are determined.*” (Italics words are suggested inserted phrases.)

We appreciate the opportunity to express our views on these important matters. We welcome the opportunity to discuss any and all issues with your board at any time.

Sincerely,

A handwritten signature in black ink, appearing to read "W.G. Bishop III". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

William G. Bishop III, Certified Internal Auditor

E-mail to: Ms. Julie Anne Dilley jdilley@aicpa.org