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Office of the Secretary
PCAOB
1666 K Street
Washington, D.C. 20006-2803

Dear Sir/Madam:

The purpose of this letter is to provide commentary regarding PCAOB's AS 5 Exposure Draft (PCAOB Release 2006-007). At the outset, I want to state that I find many of the proposed changes in the AS 5 Exposure Draft to be beneficial—particularly the risk-based approach to control testing and the clarifications regarding the role of materiality in planning tests of controls. In particular, the materiality discussion in the AS 5 Exposure Draft should help remove some apparent inconsistencies for planning tests of controls in AS 2.

However, I have concerns related to two groups of issues: 1) the elimination of the auditor's attestation regarding management's control evaluation process coupled with a lack of guidance to auditors in reviewing management's testing process and 2) the proposed change in guidance to auditors who discover material misstatements during the audit. Both changes have been justified based on cost-benefit considerations. However, irrespective of whether these proposed changes save costs, I believe that the Sarbanes-Oxley (SOX) Act of 2002 will be weakened. I am fearful that the proposed changes may encourage a return to the aggressive financial reporting environment existing prior to SOX. In short, I believe that the negative impact on the reliability of financial statement information from these two changes will outweigh any potential cost savings that might accrue. For this reason, I do not believe that these two changes are in the public interest and I would strongly encourage the PCAOB to reconsider their position. In the following paragraphs, I enumerate my concerns and attempt to present arguments against these proposed changes.

Elimination of Attestation regarding the Adequacy of Management's Tests

The Sarbanes-Oxley Act (SOX) of 2002 requires management to perform an evaluation of disclosure controls on a quarterly basis and to evaluate all other controls having a material impact on financial statements on an annual basis. Currently, PCAOB Audit Standard 2 requires the auditor to perform an attestation on management's evaluation process that culminates in the expression of an opinion as to whether the auditor believes that management's evaluation process was adequate in scope and whether the auditor concludes that management's evaluation of the control system fairly presents.

The PCAOB, in the AS 5 Exposure Draft, has recently proposed the elimination of this attestation based on three arguments. The first argument, attributed to comments received from registrants (see page 15 of the AS 5 Exposure Draft) is that, "commentators have expressed concern that auditors were performing detailed testing, such as retesting items tested by management." A second, supporting argument (see page 15) is that, "auditors are inappropriately dictating how management should perform its evaluation." The third and main argument advanced by the PCAOB is that, eliminating the auditor's attestation regarding the adequacy of management's tests, will simplify the auditor's control report and eliminate unnecessary audit test work.

Regarding the first argument against attestation, I would agree that retesting management's work would appear to be excessive. However, one reason that this retesting problem may have occurred is that PCAOB's AS 2 currently provides extremely limited guidance to auditors in performing an attestation on the adequacy of management's tests. Rather, than abandoning the attestation entirely as proposed in the AS 5 Exposure Draft, I would encourage the PCAOB to provide auditors with better guidance in this area. Similarly, the alleged problem of the auditor's dictating to management how controls should be tested can be traced to the absence of guidance being provided to management by the SEC. Thus, AS 2 became (by default) the only guidance available to management. Fortunately, the SEC has responded to this problem by recently issuing new guidance to management in performing their evaluation process.

The central argument advanced by the PCAOB for dropping the attestation, however, is to eliminate unnecessary costs. Implicit in the PCAOB's argument is the assumption that the information being provided (to both the auditor and, ultimately, to financial statement users) from the attestation process is essentially redundant and, thus, does not provide benefit commensurate with its cost. On page 16, the AS 5 Exposure draft goes even further by stating that, "the Board also believes that the auditor can perform an effective audit of internal control without conducting an evaluation of the adequacy of management's evaluation process."

I take issue with the PCAOB's position for several reasons. First, if the auditor's attestation were to be dropped, financial statement users will be deprived of assurance that management has actually fulfilled its control testing obligation under SOX. As I argue below, this has the potential of undermining registrants' compliance with SOX. Second, the PCAOB's position fails to recognize the potential information being provided to the auditor about the effectiveness of controls. I contend that, even if the

attestation report on management's testing process were to be eliminated, auditors still should have reason to evaluate the adequacy of management's testing process. An important component of the COSO framework currently used in evaluating controls includes regulatory compliance. Failure on the part of management to test its controls adequately would lead to a high risk of violating SOX. Furthermore, inadequate testing would also be a strong indicator of a bad "tone at the top" and/or incompetent internal auditing--both indicative of a weak control environment. Thus, the evaluation of management's testing process can provide the auditor with potentially strong evidence regarding management's commitment to maintaining an effective control system and also evidence regarding the capability of the internal auditors who are likely to perform many of the tests on behalf of management. Such an understanding of the control environment is of critical importance in implementing the "top-down" risk assessment perspective now being advocated (an overarching objective of the AS 5 Exposure Draft.) Thus, my response to question 14 (see page 18) of the Exposure Draft is that the auditor cannot perform an effective audit of internal control within the COSO framework without evaluating the quality of management's testing process.

Perhaps an even more serious concern is that the AS 5 Exposure Draft is virtually silent regarding the importance of reviewing management's testing process when evaluating the control environment (see paragraphs 19 and 20). Thus, if the separate attestation requirement were to be removed, there is no reason to believe that auditors following the guidance in the AS 5 Exposure Draft would necessarily perform an in-depth review of management's testing process.

The close parallel between the control evaluation process used by management and the auditor during the past three years may have created the appearance of redundancy and also contributed to the perception by some managers that auditors are dictating how their controls are to be evaluated. However, this parallel structure is unlikely to continue in the future. Indeed, the recent SEC guidance encourages management to develop their own control testing approaches rather than simply following the auditor's guidance in AS 2—a recommendation that I fully support. An important point to keep in mind is that the testing objectives of management are somewhat different from those of the auditor. To ensure that the effectiveness of controls is maintained consistently throughout the period, it is important that management evaluate the performance of its controls on an ongoing basis. Ideally, management's control evaluation process should <u>not</u> be a once-a-year test performed over a narrow time interval like the external auditor's evaluation process. Rather, it should be a continuous, ongoing process that ensures that any control weaknesses are promptly brought to the attention of management and remediated at interim subject to cost-benefit considerations. Absent an ongoing control evaluation process by management, there is no assurance that interim (quarterly) financial statements and disclosures will be reliable. The auditor's attestation report on management's evaluation process should provide assurance to users and regulators that management is in fact performing its fiduciary responsibility of monitoring control effectiveness on an ongoing basis and, in particular that management has performed quarterly evaluations of disclosure controls as required by SOX.

A further argument in favor of retaining attestation is that the auditor's evaluation process drives expectations and, thus, exerts a strong motivational effect on management and internal auditors to get their testing "right." The rigorous and timely testing by management and the internal auditors, in turn, will motivate employees who perform control activities to be more careful and attentive to their responsibilities when they know that their performance is being evaluated. Furthermore, rigorous and timely testing by management makes it more likely that any existing control problems will in fact be identified and, thus, helps to strengthen the overall effectiveness of the control system. If the external auditor's evaluation and report on management's control evaluation were to be eliminated, management may not have the same incentives to test its controls as rigorously or as frequently as is now the case. Thus, the auditor's evaluation of management's control testing process not only enables the auditor to obtain a deeper understanding of the control environment—it also has the potential to help motivate management and, in turn, client employees to maintain a strong control environment.

While I have argued that the auditor's evaluation of management's control testing process is important in encouraging compliance with Section 404 for all corporations, the testing of management's evaluation process is likely to be of critical importance in the future. As the 404 requirements are gradually extended to a wider group of firms, smaller firms will become subject to 404 requirements. Smaller firms are less likely to have the same degree of internal audit capability as larger firms and, thus, are likely to derive an even greater benefit from having their control testing process evaluated than would larger, more mature firms. Thus, as smaller firms become subject to SOX, the benefits of having auditors attest to the adequacy of management's control testing process should grow over time. Furthermore, to the extent that auditors become more efficient in performing this attestation, this attestation cost should decline over time as both management and the auditor become more experienced in performing their respective testing processes. Rather than eliminating this attestation, I would strongly encourage the PCAOB to move in the opposite direction by providing additional guidance to auditors in performing their evaluations of management's testing process.

Given the importance of management's tests of controls under SOX, I would also encourage the PCAOB to add "inadequate control testing by management" as a "strong indicator of a material weakness" or else identify it as a specific example of a weak "general control environment." (Failure by the audit committee and management to remediate significant deficiencies is the example now cited in AS 5 for a "weak general control environment.")

Guidance Regarding Strong Indicators of Material Weaknesses

Under AS 2, a material weakness exists when the auditor concludes that a material misstatement could occur with a higher than remote probability. The AS 5 Exposure Draft replaces the "higher than remote probability" with "reasonable possibility." I have no problem with this definitional change in the AS 5 Exposure Draft. However, I do have major reservations regarding related changes in the guidance to auditors.

Currently, PCAOB's AS 2 (see paragraph 140) identifies six conditions that are "at least significant deficiencies and strong indicators of a material control weakness." The six conditions are: 1) restatement of previously issued financial statements (for reasons other than a change in accounting principles), 2) identification by auditor of material misstatements in the current period's financial statements that were not detected by the control system, 3) ineffective oversight by the audit committee over the financial reporting process, 4) ineffective internal audit function, 5) fraud perpetrated by senior management, and 6) an ineffective control environment.

In my opinion, AS 2 makes a conceptual error in lumping the auditor's identification of an undetected material misstatement together with the other five indicators and, unfortunately, the AS 5 Exposure draft perpetuates this error. My point is that the auditor's discovery of an undetected material misstatement in the current period's financial statements is not merely an indicator of a material weakness, but is by definition a material weakness (under either the existing AS 2 criteria or under the AS 5 Exposure Draft criteria). (The remote probability condition (or reasonable possibility condition) is certainly satisfied whenever at least one material misstatement has already been detected by the auditor.) Thus, I would encourage the PCAOB to recognize this important distinction in its new standard.

A related change introduced by the AS 5 Exposure draft is to remove the statement that the six indicators are "at least significant deficiencies." The AS 5 Exposure Draft supports this proposed change by arguing (see p. 11 of the Exposure Draft) that, "[eliminating the significant deficiency] would reaffirm the degree of judgment required to make these evaluations."

I agree with the point that all control evaluations involve judgment on the part of auditors, but I personally cannot envision any possible scenario wherein the discovery of an undetected material misstatement by the auditor would <u>not</u> imply at least a significant deficiency. Indeed, as discussed above, I believe that the auditor's discovery of an undetected material misstatement provides the strongest possible evidence of a material weakness. How could members of the audit committee or the auditor possibly conclude that controls provide reasonable assurance that financial statements are reliable in the face of the auditor's discovery of an undetected material misstatement? Although the discovery of a material misstatement should not be necessary to conclude that a material weakness exists, it certainly is sufficient. By pooling the undetected material misstatement event into the six "strong indicators" group, and then eliminating the "at least significant deficiency" wording, the AS5 Exposure Draft makes it possible for an auditor to reach the absurd conclusion that controls are effective even after finding a material misstatement. Given that evaluation, the auditor would be under no obligation under the AS 5 Exposure Draft even to notify the audit committee or the public.

I would now like to discuss the material misstatement issue in greater detail. Some have argued that many misstatements are due to GAAP issues and that they do not necessarily imply that there is a control weakness <u>per</u> <u>se</u>. However, AS 2 in its discussion of the six

"strong indicators" is careful to make clear that they mean restatements associated with error or fraud and by stating that restatements associated with changes in accounting principles are excluded. A second argument for changing AS 2 guidance is that misapplications of GAAP are often due to complexity, rather than to control problems per se. Thus, advocates of this position would argue that auditors should be allowed to give their clients passes when they make errors in applying GAAP.

When considering the complexity issue, however, it is important not to lose sight of the fact that firms have a fundamental obligation to disseminate reliable financial statement information. This obligation requires firms who routinely engage in complex financial transactions to recognize the elevated risk of non-compliance with GAAP and to maintain sufficient accounting expertise to manage their financial reporting process in the face of complexity just as is done in the tax reporting domain. SOX also makes explicit the registrant's obligation to maintain effective controls to protect the financial reporting process in contexts where inherent reporting risks are high. Given the central role of accounting policies in the financial reporting process, management should be cognizant of the elevated risks and impose controls that are commensurate with the elevated risk due to complexity. Thus, a firm's failure to manage the risks associated with its accounting policies in such an environment is perhaps the strongest possible example of a material weakness in controls over the financial reporting process. For this reason, I do not believe that complexity really provides a justification for failing to conclude that there is not a material weakness—much less a significant deficiency.

Currently, despite the "strong indicator" guidance in AS 2, there are numerous examples where auditors have issued unqualified reports on controls and current period financial statements after the client has restated the prior period's financial statements. (Compliance Week statistics indicate that many firms making restatements have not received adverse control reports.) Perhaps most of the firms who made restatements changed their GAAP or were able to remediate their control problems in time for the auditor to re-test before year-end. However, I remain a bit skeptical when many of the firms receiving unqualified control reports after restatements have gone through yet another round of restatements during the following year. I fear that the proposed softening of the AS 2 guidance will only weaken the ability of auditors to withstand client pressure and encourage to the aggressive reporting days of the late 1990's.

In summary, I believe that the auditor's finding of a material misstatement must be separated from the other material weakness indicators and that guidance should be strengthened rather than weakened. I personally would favor language to the effect that the finding of an undetected material misstatement during the current year's audit (whether it relates to a transaction in the current year or a prior year) is clearly sufficient (but not necessary) for the issuance of an adverse opinion. I would also state that the presence of one or more of the other five indicators should create the presumption of a material weakness. This would place the burden squarely on the auditor to justify not issuing an adverse audit report in the presence of such indicators. Strengthening, rather than weakening the guidance to auditors will help to ensure that, regulators and other financial statement users will not be deprived of an early warning signal regarding

reliability issues in the client's financial reporting process. I also urge the PCAOB to retain the auditor's attestation report on the adequacy of management's control evaluation process. Maintaining the attestation will help to ensure that auditors obtain a deep understanding of their clients' control environments and also help strengthen their clients' control environments by enhancing managers' incentives to test their controls robustly so that weaknesses can be identified and remediated. Ultimately, this will allow management to develop more efficient and effective audits of control systems to enhance the reliability of the financial reporting system.

I fully support the SEC's position that management should have greater flexibility in testing, but I would stress the need for the SEC to provide guidance about performing control evaluations on an ongoing basis throughout the year rather than attempting to mimic the testing performed by the external auditor near year-end. Similarly, the PCAOB should provide more guidance to auditors in structuring their tests of the adequacy of management's control tests, rather than abandoning the attestation altogether. These changes in guidance would help to make management's control evaluation process complementary to the evaluation process performed by the external auditor. I hope that the PCAOB's current focus on reducing short-term SOX compliance costs does not inadvertently undermine Congressional intent in passing SOX to enhance the reliability of the financial reporting process.

Respectfully,

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