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financial executives
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February 26, 2007

Office of the Secretary
PCAOB
1666 K Street NW
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 021

Financial Executives International ("FEI") appreciates the opportunity to provide its views on the Public Company Accounting Oversight Board ("PCAOB") proposed auditing standards, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* and *Considering and Using the Work of Others in an Audit* ("proposed standards").

FEI responds to such requests through its technical committees. As a result, I have attached two letters from FEI's Committee on Corporate Reporting ("CCR") and FEI's Small Public Company Task Force ("SPCTF") in response to the PCAOB's proposed auditing standards.

Thank you again for the opportunity to provide our comments.

Sincerely,

Grace Hinchman

Grace L. Hinchman
Senior Vice President
Financial Executives International

fei

financial executives international

committee on corporate reporting

February 26, 2007

Office of the Secretary
PCAOB
1666 K Street NW
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Re: PCAOB Rulemaking Docket Matter No. 021

The Committee on Corporate Reporting ("CCR") of Financial Executives International ("FEI") appreciates the opportunity to provide their views on the Public Company Accounting Oversight Board ("PCAOB") proposed auditing standards, *An Audit of Internal Control Over Financial Reporting ("ICFR") That Is Integrated with An Audit of Financial Statements,* and *Considering and Using the Work of Others in an Audit* ("proposed standards"). 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 or its members individually.

We agree that the proposed standards have the potential to assist auditors in making their audit process more efficient and cost-effective, as the PCAOB intended. We appreciate the thought and effort put into developing the standards. We also appreciate the fact that the PCAOB has listened to comments expressed at the two Roundtables and in other forums about the need for balance between costs and benefits of Sarbanes-Oxley compliance. The proposed standards open the door for productive dialogue with our external auditors about how to make our assessments and their audits much more efficient. We especially appreciate that the proposed standards have moved to a more principles-based approach. They allow for a high level of judgment in applying the principles to individual company situations, moving away from the one-size-fits-all approach that many companies and their auditors have been following. In particular, we support the top-down, risk-based approach. In the Appendix we have included additional comments about the benefits that we expect to derive from a more focused internal controls assessment and also specific responses to several of the questions posed in the proposed standards.

In addition to our support for the proposed standards, we have two critical concerns. First, the proposed standards must be aligned with the interpretive guidance for management proposed by the U.S. Securities and Exchange Commission ("proposed guidance"). We believe that the proposed audit standards, although much improved from the existing PCAOB Audit Standard No. 2 ("AS2"), are still more detailed and prescriptive than the proposed guidance. These differences could result in external audits that are more conservative than management assessments, which will cause companies to incur unnecessary costs to remain aligned with their external auditors.

Our second concern is that external auditors will need to be assured that the PCAOB inspection practices will align with the proposed standards. Otherwise, auditors will be reluctant to change their approach until after an inspection cycle, which can be more than a year from the time of the audit. If the intent of the inspections is to drive improvements in the auditors' approach, adherence to the proposed standards and greater consistency among the firms, then the feedback must be provided on a timely basis. Also, the 2005 inspection reports that have just been published indicate that the PCAOB inspectors were focused on identifying deficiencies in scope and procedures, not on efficiency. Unless the PCAOB can communicate a clear and convincing message that the inspection approach will change, we believe that no meaningful change will be made for 12-18 months after the effective date of the proposed standards, while auditors wait to see how the inspectors will react.

We also have several suggestions for clarifications or enhancements to the proposed standards. All suggestions are described more fully below, but the top priority items in terms of improving efficiency and effectiveness are:

- Focus on change in controls for testing, allowing for rotational testing of controls that have operated effectively in the past and have not changed, in addition to benchmarking of automated controls
- Increased reliance on company-level controls to reduce process-level testing
- Elimination of the "interim" financial statement component from the definition of material weakness
- Modification of certain detailed or prescriptive provisions of the proposed standards, such as the requirement for walkthroughs, the evaluation of **all** deficiencies even if clearly not material, and the evaluation of competence and objectivity for purposes of reliance on the work of others

**Alignment between management and external auditors**

Companies represented by CCR are ready to take advantage of the efficiencies that the proposed standards enable. To date our Sarbanes-Oxley compliance approaches have been largely driven by the audit firms. In the absence of management guidance, companies have had to follow AS2 to satisfy the requirements of the auditors.

We expect that to change with the introduction of the proposed standards. With the flexibility to focus on a top-down, risk-based approach to detect only material weaknesses, we anticipate that companies will drive to narrow their focus to the truly high risk areas, achieving a better tradeoff between the quality of controls assurance and the cost of compliance. Companies are certainly motivated to become more efficient in their compliance processes. It stands to reason that the external auditors, under the proposed standards, would be able to mirror management's efficiencies.

We want to emphasize how critical it is that the external audit standards are aligned with the proposed guidance. The auditors must be comfortable with management's assessment approach to optimize reliance and achieve overall cost savings. Although the requirement for an opinion on management's assessment process has been recommended for elimination, the opinion on the controls themselves remains. A more detailed or conservative approach on the part of the auditors will drive companies to continue to document and assess lower-risk controls, thereby continuing to incur unnecessary costs and failing to achieve the objective of more effective and efficient assessments.

We hope that external auditors are preparing to change their approach to the same extent as management. We have heard some comments from external auditors to the effect that they do not view the proposed standards as driving much of a change in their current practice as they believe that they have already been implementing a more top-down risk based approach with the issuance of May 2005 PCAOB guidance. We believe auditors have understandable concerns about the impact of PCAOB inspections, since the inspection reports issued to date have not focused on the risk of over-auditing. Some auditors seem to be taking a wait-and-see approach, anticipating guidance from the firms' national offices. Their hesitation to embrace the idea of big change is perhaps understandable. Certain auditors may actually disagree with the changes, feeling that we might be losing ground that has been gained since the passage of the Sarbanes-Oxley Act. Others could be legitimately concerned about the impact on the audit firms' revenue profile, which has been significantly enhanced by the addition of the internal controls audits in the past 2-3 years.

Barriers to change for the external auditors could manifest themselves in individual engagement teams being unwilling to make changes without support from the firm's national office, in national office guidance that interprets the standards more restrictively than intended, and/or in firms collaborating to create de facto guidance that reverts to more prescriptive language and mutes the positive changes in the proposed standards.

We believe that the PCAOB needs to be proactive in encouraging external auditors to embrace the level of significant change that the companies expect to make in their assessments. We have the following suggestions to offer:

- Additional language in the proposed standards or in the introduction to the proposed standards, giving more concrete guidance regarding the extent of change that is expected.
- Educational forums to clearly instruct the auditors in the intent of the new proposed standards and how the inspection process will also change in the same spirit.
- PCAOB inspections that support the drive for efficiency by including inspection criteria that evaluate conformance to the new proposed standard and resulting efficiencies. Those criteria should be communicated to the auditors as soon as possible to support efficiencies in the calendar year 2007 internal control audits.
- PCAOB monitoring of any multi-firm initiatives from external auditors to create supplemental guidance to the proposed standards. The PCAOB should also monitor guidance from the national offices of the firms regarding implementation of the proposed standards to make sure that firm guidance does not countermand the intent of the new standards. Any supplemental guidance that is developed should be the result of due process which involves input from industry as well as the external audit firms.

**Focus on changes in controls**

The proposed standards encourage the use of prior knowledge and audit results to guide the risk assessment and testing approach. The standards clearly allow for leveraging prior evidence in subsequent years based upon the type and results of prior years' testing and the extent of changes in the controls. Also, the proposed standards explicitly provide for benchmarking of automated controls. Using prior year knowledge and results will allow for additional reductions in audit effort.

As helpful as we expect that guidance to be, we would like to see the proposed standards explicitly provide external auditors the flexibility to focus on only **changes** in controls. This would mean changing the expectation that each control will be fully tested each year and allow for benchmarking or rotational testing of controls in areas in addition to automated controls. If the auditor could confirm that the control design had not changed and that the control had been operating effectively in past audits, the auditor should have the freedom to forgo annual testing of that control in favor of a rotational testing plan, particularly for lower risk controls. Also, the auditors could limit the scope of their walkthroughs to only the changes.

**Company-level controls**

Companies have put much thought and effort into identifying and enhancing company-level controls. Although we are confident that company-level controls are the key to preventing future Enron-type failures, in some cases it remains unclear as to how these controls can be leveraged to reduce testing of transaction level controls, particularly indirect company-level controls such as ethics programs and Board of Director oversight. Paragraphs 16 and 17 of the proposed standard indicate that a top-down approach begins with company-level controls, that those controls must be tested, and that the evaluation could result in increasing or decreasing other auditor testing. This language does not express a strong conviction that company-level controls can have a significant effect on the extent of other testing. We ask that the PCAOB reconsider whether the language could be enhanced to more strongly support giving credit for strong company-level controls, both in scoping decisions and also in decisions about which other controls to test.

Leveraging company-level controls to reduce other testing has been more successful in the case of direct company-level controls, such as analytic reviews and budget-to-actual comparisons. One issue here has been establishing the precision at which these controls operate. With the new focus on detecting material misstatements, the precision should be less of an issue. In paragraph 43 the proposed standard states that some company-level controls might adequately prevent or detect misstatements to one or more relevant assertions. We would like to see the word “material” inserted before “misstatements” twice in this paragraph to emphasize that the acceptable level of precision is higher than in the past.

One illustration that we would suggest is in the area of General IT controls. Typically management and external auditors have performed extensive testing of these controls even though the likelihood of an undetected material misstatement is not reasonably possible. When issues do arise, companies typically find that their downstream compensating controls, such as account reconciliations, supervisory reviews, and external reporting controls, mitigate the reasonable possibility of a material misstatement. It would take an issue at the overall IT control environment (company level) for a material financial reporting issue to manifest itself.

This is an area where it would be appropriate for companies to focus their efforts at the IT (indirect) company level. The company-level testing combined with individual control level testing on a rotational or focused basis (i.e., looking at points of change or high risk areas) would be an effective risk mitigation strategy in this area. We recommend that the PCAOB reconsider, at least in the IT space, that a rotational approach to transaction testing would be an acceptable in this area.

One other note is that the proposed standards use the term “company-level controls” to describe direct and indirect controls other than process level controls. The SEC guidance uses the term “entity-level controls” in a similar way.  Aligning the terms between the two documents could help eliminate some of the confusion that already exists about the definitions.

**Annual vs. interim financial statements considered in evaluating deficiencies**
The definitions of “significant deficiency” and “material weakness” in the proposed standard include a misstatement of the company’s “annual or interim financial statements.”  This language implies that a control deficiency discovered during the year would be evaluated based upon a lower materiality threshold, some fraction of annual materiality.  We believe that the deficiency evaluation should be based upon the impact on annual financial statements.  The management assessment of internal controls is an annual assessment of whether controls are operating effectively as of the end of the year.  Deficiencies discovered during the year should be evaluated in the context of a potential error on the annual financials, a forward-looking analysis with a focus on internal control weaknesses as leading indicators of potential misstatements.  The SEC proposed guidance states that, “As part of the evaluation of ICFR, management considers whether the deficiencies, individually or in combination, are material weaknesses as of the end of the fiscal year.”  For these reasons, we suggest that the reference to interim financial statements should be removed from the definitions in the proposed standard.

**Auditor judgment**
We support the changes in the proposed standards to remove much of the detailed or prescriptive guidance that was included in Audit Standard No. 2.   We believe that leaving more decisions in the hands of the individual audit engagement teams can improve efficiency and quality by tailoring the approach to the specific company circumstances.

We do want to comment on instances where the guidance remains detailed and/or prescriptive and recommend that the language be modified:

- The requirement for the auditor to perform walkthroughs remains in the proposed standards, although it is modified to require walkthroughs of only significant processes rather than each major class of transactions within each significant process.  We believe that while the walkthrough can be an effective means for gathering evidence regarding the design and even operating effectiveness of controls, it should not be required, but rather left to the auditor’s judgment.

- Paragraph 70 requires that the auditor evaluate the severity of each control deficiency that comes to his or her attention, even though he/she is not required to search for deficiencies that are less severe than a material weakness.  We believe that this is not necessary, and that an acceptable alternative would be for the auditor to verify that management has evaluated all deficiencies.

**Reliance by auditors on the work of others**
The second proposed standard expands the potential for auditor reliance on the work of others, which should further reduce the costs of external audits and better align the audit and the management assessment.  The proposed standard defines guidelines for competence and objectivity that could expand reliance on work by company employees and contractors other than internal audit.  It removes the “principal evidence” requirement and also removes the requirement for original work in testing of controls in the control environment.  We believe that these changes will be effective in facilitating greater reliance and lower costs.

The proposed standard includes factors to consider in the external auditor's evaluation of competence and objectivity to determine the appropriate level of reliance on the work of others. The criteria seem comprehensive, but we have concerns about how the auditors will obtain and document their satisfaction with competence and objectivity based on these somewhat detailed criteria. If the auditor felt compelled to satisfy several of the criteria listed, gathering and reviewing documentation of competence and objectivity could be onerous. We also believe that the focus on organizational status could be interpreted quite restrictively to direct the auditor to rely only on the work of internal audit. Many companies have established successful programs of using line testers who have deep knowledge of the processes and controls. In many cases, they are equally or more competent and objective than internal audit.

We believe that competence and objectivity can be appropriately judged by the external auditors in individual company situations without being constrained by factors specified in the proposed standard. Therefore, we would like to see paragraphs 14 and 15 removed from the proposed standard and let the auditor apply his/her judgment in evaluating competence and objectivity.

**Removal of opinion on management's assessment**

We support the elimination of the opinion on management's assessment process. Although we do not expect to see substantial efficiencies result from the change, we believe that the opinion on the management assessment is superfluous and should be eliminated. If companies want to optimize auditor reliance on management testing, they will still need to mirror the auditors' standards of testing and documentation. However, the elimination of the opinion gives companies the leeway to make that decision, as opposed to the current environment where all companies are compelled to conform their assessments to AS2 standards.

**Multiple-location changes**

Changes in the multiple-location guidance are important to CCR, especially for companies that are very decentralized and complex. We believe that the shift to a risk-based approach will allow companies to vary testing in locations based more on risk than on coverage and will certainly improve efficiency, significantly in some cases.

**Deficiency evaluation**

The change in the likelihood component of the material weakness and significant deficiency definitions from "more than remote" to "reasonable possibility" should reduce the time spent on evaluating deficiencies. The change in the magnitude component of the significant deficiency definition from "more than inconsequential" to "significant" should raise the threshold for significant deficiencies and also allow for increased judgment in determining significant deficiencies.

The proposed standards include factors to consider in evaluating the likelihood and magnitude of a control deficiency or combination of deficiencies, as well as indicators of significant deficiencies and material weaknesses. Many external auditors and companies have been using a deficiency evaluation framework that was created by the larger audit firms. This framework focuses on a quantitative and mechanical approach that is counter to the concept of a risk-based evaluation approach. We believe that the factors in the proposed standards can be used in lieu of the framework and recommend that the proposed standard includes a statement that discourages the use of the existing framework.

### Detection of fraud

The proposed standard states in paragraph 45 that, along with other assertions, auditors should address controls that mitigate the risk of material misstatement due to fraud. This clarification is helpful as it has been unclear whether companies and external auditors should be identifying and assessing controls that would detect ANY fraud committed by a senior executive. Contradicting that point, however, is the language in paragraph 79 which says that fraud of any magnitude on the part of senior management is an indicator of a material weakness. It may be more appropriate to remove that statement from paragraph 79 and include a statement about senior management fraud in paragraph 78, which discusses deficiencies that would ordinarily result in at least significant deficiencies. It may also be appropriate to define the specific types of fraud that should be considered to be an indicator of a material weakness (e.g., intentional manipulation of financial statements, versus misappropriation of assets). Also, the definition of senior management seems fairly broad. Adding the term "senior" to the last sentence in the note on the top of Page A1-30 of the proposed standard would make the definition more consistent.

### Wording of the audit opinion

The unqualified opinion example in paragraph 96 still includes the language, "We also have audited management's assessment", even though the last sentence of the sample opinion says that "Our responsibility is to express….an opinion on the company's internal control over financial reporting based on our audits." And the final opinion paragraph states, "Also in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting…." With the proposed elimination of the requirement for a separate opinion on management's assessment process, the above language in the introductory paragraph of the opinion is potentially misleading or confusing, even in light of the fact that the direct audit of the internal controls gives indirect assurance about management's assessment process.

We believe that the language should be changed to indicate that the external auditors are auditing the internal controls themselves, not management's assessment of the controls. Or alternatively, to continue to address the requirement of Section 404(b) of the Sarbanes-Oxley Act of 2002 that the auditors attest to, and report on, the assessment made by the management of the issuer, the language could be changed to state explicitly that the auditors have audited management's assessment by performing a direct audit of the internal controls.

The audit of management's assessment is also referenced in paragraph 1 of the proposed standard, and we suggest that language should also be changed to remove the words "of management's assessment" in that paragraph.

### Effective date

We hope that we have clearly communicated our strong support for the proposed standards. To allow companies to realize the expected benefits in the near future, we suggest that the proposed standards and the proposed guidance should be implemented as soon as possible. For the benefit of calendar year companies, the effective date should be as early as possible in calendar year 2007. To minimize disruption and inefficiency, the proposed standards need to be effective before design evaluations begin for calendar year companies, which would typically begin in the second quarter.

In addition to the above comments, the Appendix to this letter includes responses to several of the specific questions raised by the PCAOB in the cover letter accompanying the proposed standards.

Thank you for considering our views. We would be happy to discuss our comments and recommendations at your convenience.

Lawrence J Salva

Lawrence J. Salva
Chair, Committee on Corporate Reporting
Financial Executives International

## APPENDIX

Responses to Questions

1. Does the proposed standard clearly describe how to use a top-down approach to auditing internal control?

*We believe that the standard does clearly describe a top-down approach. The primary driver of efficiency will be the focus on a top-down, risk-assessed approach. The focus on key critical controls that would detect a material misstatement, rather than a significant deficiency, creates the possibility that auditors can significantly reduce the number of key controls to be assessed. This reduction will allow for a lower audit effort overall and more attention and focus on the critical controls, which should increase the likelihood that any existing material weakness would be discovered and remediated.*

*The auditor is directed to focus on the same significant accounts as for the financial statement audit and the relevant assertions, based upon an assessment of risk. After determining major classes of transactions and significant processes, the auditor focuses on control activities in those processes that address the risk of misstatement to each relevant assertion for each significant account. The proposed standard states there might be more than one control for a relevant assertion or one control might address more than one relevant assertion. The suggestion that there could be a one-to-one or a one-to-many relationship between key controls and relevant assertions for each account leads to the conclusion that the number of key controls to be tested will likely be much lower than the current number. A reduction in the controls tested will improve both efficiency and quality.*

*The proposed standards also suggest that risk assessments drive several audit decisions, in each case limiting the extent of audit work. First, the identification of significant accounts to include in scope is based upon an assessment of the risk of potential material misstatement in the account. Relevant assertions are also chosen based upon a risk assessment, asking the question of "what could go wrong" with in-scope accounts. Once key controls are identified, the risk of the control not operating effectively is assessed to determine the nature and extent of testing evidence to be obtained. For companies with multiple locations, the changes in the multi-location guidance shift from an emphasis on coverage to an emphasis on identifying and including locations based on risk. At each decision point, the application of thoughtful risk assessments should reduce and focus the audit effort, as compared to the effort expended under the current standard.*

*One small point of clarification might be to specify in Paragraph 16 that indirect company-level controls should be considered in determining the risk level of significant accounts. The paragraph says to begin with company-level controls, but does not specify how they are to be considered.*

2. Does the proposed standard place appropriate emphasis on the importance of identifying and testing controls designed to prevent or detect fraud?

*The proposed standard states in paragraph 45 that, along with other assertions, auditors should address controls that mitigate the risk of material misstatement due to fraud. This clarification is helpful as it has been unclear whether companies and auditors should be identifying and assessing controls that would detect ANY fraud committed by a senior executive. Contradicting that point, however, is the language in paragraph 79* *which says that fraud of any magnitude on the part of senior management is an indicator of a material weakness. It may be more appropriate to remove that statement from paragraph 79 and include a statement about senior management fraud in paragraph 78, which discusses deficiencies that would ordinarily result in at least significant deficiencies. It may also be appropriate to define the specific types of fraud that should be considered to be an indicator of a material weakness (e.g., intentional manipulation of financial statements, versus misappropriation of assets). Also, the definition of senior management seems fairly broad. Adding the term "senior" to the last sentence in the Note on the top of Page A1-30 of the Standard would make the definition more consistent.*

3. Will the top-down approach better focus the auditor's attention on the most important controls?

*Yes, we believe that the proposed standard sets the expectation that there would be one or a small number of controls for each combination of significant account/disclosure and relevant assertion. The proposed standard mentions that the auditor should test only those controls necessary to obtain reasonable assurance. Paragraph 42 reinforces that there might be one or more than one control for a particular relevant assertion and that it is not necessary to test all controls or to test redundant controls. This guidance should encourage a truly fresh look at the controls that are in scope for testing and enable auditors to significantly reduce the number of controls that are tested. This reduction will allow for better focus on the critical controls.*

4. Does the proposed standard adequately articulate the appropriate consideration of company-level controls and their effect on the auditor's work, including adequate description of when the testing of other controls can be reduced or eliminated?

*Companies have put much thought and effort into identifying and enhancing company-level controls. Although we are confident that company-level controls are the key to preventing future Enron-type failures, in some cases it remains unclear as to how these controls can be leveraged to reduce testing of transaction level controls, particularly indirect company-level controls such as ethics programs and Board of Director oversight. Paragraphs 16 and 17 of the proposed standard indicate that a top-down approach begins with company-level controls, that those controls must be tested, and that the evaluation could result in increasing or decreasing other auditor testing. This language does not express a strong conviction that company-level controls can have a significant effect on the extent of other testing. We ask that the PCAOB reconsider whether the language could be enhanced to more strongly support giving credit for strong company-level controls.*

*The term 'company-level' control is used to encompass a variety of controls that are directly and indirectly related to significant accounts. It might be helpful to draw this distinction, as it has been drawn in the SEC guidance. Also the standard could explain that* ***indirect*** *company level controls can/should be used in assessing the risk of significant accounts and controls and that* ***direct*** *company-level controls could be chosen as key controls to be tested. If the distinction is made between indirect and direct company-level controls, examples of direct controls would be helpful. The controls mentioned in paragraph 18 would be indirect controls.*

*One example that could be included is in the area of General IT controls. Typically management and auditors have performed extensive testing of these controls even though the likelihood of an undetected material misstatement is not reasonably possible.*

*When issues do arise, companies typically find that their downstream compensating controls, such as account reconciliations, supervisory reviews, and external reporting controls, mitigate the reasonable possibility of a material misstatement. It would take an issue at the overall IT control environment (company level) for a material financial reporting issue to manifest itself.*

*This is an area where it would be appropriate for companies to focus their efforts at the IT (indirect) company level. The company-level testing combined with individual control level testing on a rotational or focused basis (i.e., looking at points of change or problem areas) would be an effective risk mitigation strategy in this area. We recommend that the PCAOB reconsider, at least in the IT space, that a rotational approach to transaction testing would be acceptable in this area.*

*Other company-level controls that can be leveraged to reduce testing of process level controls are variance analyses and senior level reviews. CCR would be willing to work with the PCAOB in developing other examples.*

*One other note is that the proposed standards use the term "company-level controls" to describe direct and indirect controls other than process level controls. The SEC guidance uses the term "entity-level controls" in a similar way. Aligning the terms between the two documents could help eliminate some of the confusion that already exists about the definitions.*

5. Does the proposed standard appropriately incorporate risk assessment, including in the description of the relationship between the level of risk and the necessary evidence?

*Both the proposed standards and the SEC guidance discuss two types of risk assessment: assessing the risk of misstatement to financial statement elements and separately assessing the risk of key controls not operating as designed. By separating the discussion of risk factors between significant accounts and control activities, the guidance raises the possibility to vary the extent of testing of controls based upon their own risk characteristics. Thus, a low risk control activity could have limited testing even though it mitigates a high risk account. Being able to differentiate the type and extent of testing will be very helpful in improving efficiency.*

*The risk assessment discussion in the proposed standards should also guide auditors to eliminate excessive or redundant testing and allow for varying testing based upon prior knowledge of the company, prior testing results, and entity-level (company-level) controls. The proposed standards contain a good description of risk factors in determining both significant account risk (paragraph 26) and operating effectiveness risk (paragraph 52).*

6. Would the performance of a walkthrough be sufficient to test the design and operating effectiveness of some lower risk controls?

*Yes, we believe that a walkthrough could be sufficient. Being able to rely solely on a walkthrough seems most likely for controls in smaller companies and for entity-level controls, or for other controls where there is not documentary evidence and the effectiveness of the control relies heavily on the expertise of the person performing the control. In addition, for other process-level controls with a strong history of operating effectiveness, a stable control environment and positive prior test results (criteria discussed in paragraph 66), a walkthrough might also be sufficient. Giving the auditors the freedom to make this judgment is a positive step.*

7. Is the proposed definition of "significant" sufficiently descriptive to be applied in practice? Does it appropriately describe the kinds of potential misstatements that should lead the auditor to conclude that a control deficiency is a significant deficiency?

*The definition is probably sufficient.  We believe that the phrase "less than material yet important enough to merit attention" will raise the threshold of magnitude above the current level of "more than inconsequential."*

*Another observation is that the "prudent official" language in paragraph 77 does not include any qualifier based upon magnitude of deficiency.  Reading this paragraph as currently stated would imply that any error in transactions not in conformity with GAAP could result in a significant deficiency.*

8. Are auditors appropriately identifying material weaknesses in the absence of an actual material misstatement, whether identified by management or the auditor? How could the proposed standard on auditing internal control further encourage auditors to appropriately identify material weaknesses when an actual material misstatement has not occurred?

*We have no reason to believe that auditors are not appropriately identifying material weaknesses.  The language in the proposed standards seems to be quite clear that internal control deficiencies need to be evaluated based on the magnitude of the potential error and the likeliness that it could occur, even in the absence of an actual misstatement.  By focusing auditor attention on far fewer key controls, we believe that the likelihood of identifying material weaknesses in controls in advance of actual misstatements will increase.*

9. Will the proposed changes to the definitions reduce the amount of effort devoted to identifying and analyzing deficiencies that do not present a reasonable possibility of material misstatement to the financial statements?

*We believe that the definitional changes will reduce the effort spent in analyzing deficiencies, but probably not to a large degree.  The "significant deficiency" category still exists and the deficiency evaluation therefore will still have to address the distinction between deficiencies and significant deficiencies.   We expect that the change in the threshold for likelihood ("more than remote" changing to "reasonable possibility") will reduce the time spent on trying to define the line between deficiency and significant deficiencies.  And there should be fewer deficiencies to evaluate overall because there will be fewer controls being tested.*

*As mentioned above, using the factors in the proposed standards and in the SEC guidance in the deficiency evaluation, rather than the framework currently in use, should reduce the amount of effort devoted to analyzing deficiencies.  We also believe that it is not necessary for the auditor to evaluate the severity of each control deficiency that comes to his/her attention.  An acceptable alternative would be for the auditor to verify that management has evaluated all deficiencies.*

10. Should the standard allow an auditor to conclude that no deficiency exists when one of the strong indicators is present?  Will this change improve practice by allowing the use of greater judgment?  Will this change lead to inconsistency in the evaluation of deficiencies?

*In the spirit of encouraging auditor judgment and improving the audits of internal controls, the auditor should be allowed to conclude that no deficiency exists even in the presence of one of the strong indicators. We expect that the auditor would be able to thoroughly document his/her thought process and conclusions in these situations. It seems unlikely that the auditor would conclude that no deficiency exists, but we believe that it could be possible.*

*The use of greater auditor judgment will improve practice in that the auditors will be more thoughtful in their evaluations and conclusions of the specific client situations, rather than following a "check-box" approach. We believe that inconsistencies exist today, even with more prescriptive standards. Whether the inconsistencies will increase or decrease is difficult to predict, but we believe the benefits of increased auditor judgment will outweigh the risk of additional inconsistencies.*

11. Are further clarifications to the scope of the audit of internal control needed to avoid unnecessary testing?

*As mentioned in response to question #4, additional examples of company-level controls that could be relied upon instead of multiple process-level controls would also be helpful.*

12. Should the reference to interim financial statements be removed from the definitions of significant deficiency and material weakness? If so, what would be the effect on the scope of the audit?

*The definitions of "significant deficiency" and "material weakness" in the proposed standard include a misstatement of the company's "annual or interim financial statements." This language implies that a control deficiency discovered during the year would be evaluated based upon a lower materiality threshold, some fraction of annual materiality. We believe that the deficiency evaluation should be based upon the impact on annual financial statements. The management assessment of internal controls is an annual assessment of whether controls are operating effectively as of the end of the year. Deficiencies discovered during the year should be evaluated in the context of a potential error on the annual financial statements, a forward-looking analysis with a focus on internal control weaknesses as leading indicators of potential misstatements. The SEC guidance states that, "As part of the evaluation of ICFR, management considers whether the deficiencies, individually or in combination, are material weaknesses as of the end of the fiscal year." For these reasons, we suggest that the reference to interim financial statements should be removed from the definitions in the proposed standard.*

13. Will removing the requirement for an evaluation of management's process eliminate unnecessary audit work?

*We believe that it will eliminate some unnecessary work, but probably not much. What we hear from our external auditors is that they do not spend much additional time directly auditing management testing practices, but rather are able to infer the quality of the assessment as they directly audit the internal controls. In our experience, the auditors' recording and evaluating deficiencies that result from management assessment practices represent a small portion of the total deficiency evaluation. Furthermore, for the most part, the management assessment process will need to continue to operate at a level of quality that would be acceptable to the auditors in order to allow the auditors to rely on a portion of management's work. And finally, the auditor reliance on* *management work will require some ongoing retesting of management's assessments, which may not be much different from what is done today.*

14. Can the auditor perform an effective audit of internal control without performing an evaluation of the quality of management's process?

*If this question refers to evaluating the quality of management's process of assessing its own controls, then yes, it would be possible to perform an audit without evaluating the quality of management's process. However, this would be true only under the following conditions: 1) no reliance on management's work; and 2) the assessment process is separate from the operation of the controls. To the extent that management's assessment process draws on monitoring processes or controls, those controls would automatically be subject to the audit. As mentioned above, we believe that as a practical matter, the external auditors will continue to perform some type of evaluation of management's assessment process, even though they are no longer required to express a separate opinion on the process.*

15. Will an opinion only on the effectiveness of internal control, and not on management's assessment, more clearly communicate the scope and results of the auditor's work?

*We believe that investors would expect auditors to opine on the controls themselves and that would be more valuable than an opinion on management's assessment process. We believe that the primary benefit of removing the requirement for a separate opinion on management's assessment is efficiency, not clarifying communication.*

*The unqualified opinion example in paragraph 96 still includes the language, "We also have audited management's assessment", even though the last sentence of the sample opinion says that "Our responsibility is to express….an opinion on the company's internal control over financial reporting based on our audits." And the final opinion paragraph states, "Also in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting…." With the elimination of the requirement for a separate opinion on management's assessment process, the above language in the introductory paragraph of the opinion is potentially misleading or confusing, even in light of the fact that the direct audit of the internal controls gives indirect assurance about management's assessment process.*

*We believe that the language should be changed to indicate that the external auditors are auditing the internal controls themselves, not management's assessment of the controls. Or alternatively, to continue to address the requirement of Section 404(b) of the Sarbanes-Oxley Act of 2002 that the auditors attest to, and report on, the assessment made by the management of the issuer, the language could be changed to state explicitly that the auditors have audited management's assessment by performing a direct audit of the internal controls.*

*The audit of management's assessment is also referenced in paragraph 1 of the proposed standard, and we suggest that language should also be changed to remove the words "of management's assessment" in that paragraph.*

16. Does the proposed standard appropriately incorporate the value of cumulative knowledge?

*In spite of the discussion about incorporating prior year information and results to guide the extent of testing in paragraphs 65 through 69, the proposed standards do not address the current practice of requiring some type of assessment of each control each year, except in specifically providing for benchmarking of automated controls. We would like to see the proposed standards go farther in allowing for the possibility of rotating or benchmarking of controls in other areas as well, including not testing a control each year if the auditor could confirm that the control design had not changed and that the control had been operating effectively in past audits.*

*In addition to benchmarking of automated controls, we believe that the testing of general IT controls could lend itself to rotation. Typically management and external auditors have performed extensive testing of these controls even though the likelihood of an undetected material misstatement is not reasonably possible. This is an area where companies could focus their efforts on company-level testing combined with individual control level testing on a rotational or focused basis (i.e., looking at points of change or problem areas) as an effective risk mitigation strategy in this area.*

17. What are the circumstances in which it would be appropriate for the auditor to rely upon the walkthrough procedures as sufficient evidence of operating effectiveness?

*See response to question 6 above*

18. Will the proposed standard's approach for determining the scope of testing in a multi-location engagement result in more efficient multi-location audits?

*The approach should result in more efficient multi-location audits. Introducing more judgment in a risk-based approach could eliminate or vary the testing in locations that have been included to satisfy the more restrictive language in AS2 or to achieve certain expected levels of coverage. We see three potential advantages of the new multi-location approach: 1) It will encourage auditors and companies to think critically about each location that has been in scope and consider location-specific risks with the result of making the audit more efficient; 2) It might cause companies and auditors to uncover additional location-specific risks that had not been thoroughly considered previously if a location was included in scope without careful evaluation; and 3) It will encourage auditors and companies to look for higher-level, centralized, potentially stronger monitoring-type controls that could cover more locations and dollars. Of the three benefits, the one that will probably be most pervasive is the efficiency that will be gained by eliminating detailed testing in some locations.*

19. Is the proposed standard's single framework for using the work of others appropriate for both an integrated audit and an audit of only financial statements? If different frameworks are necessary, how should the Board minimize the barriers to integration that might result?

*Because the financial statement and internal control audits must be integrated to achieve the desired results, it seems appropriate to propose a single framework for using the work of others. It would not be appropriate to have a different set of standards for the two different audit objectives*.

20. Does the proposed definition of relevant activities adequately capture the correct scope of activities, including activities that are part of the monitoring component of internal control frameworks?

*Defining relevant activities as "tests performed by others that provide evidence about the design and operational effectiveness" implies that separate direct testing is performed. Monitoring activities that could legitimately be relied upon by the external auditors might be excluded because these activities might not be construed to be "tests." The definition therefore seems limiting, and could be changed to read "activities" or "assessments" or "evaluations" rather than "tests."*

21. Will requiring the auditor to understand whether relevant activities performed by others identified control deficiencies, fraud, or financial statement misstatements improve audit quality?

*Yes, understanding the control deficiencies identified by relevant activities performed by others seems to be one of the minimum requirements that should be in place to allow reliance on those activities by the external auditors.*

22. Is the principal evidence provision that was in AS No. 2 necessary to adequately address the auditor's responsibilities to obtain sufficient evidence?

*We don't believe that it is necessary. It seems reasonable to remove the principal evidence provision and to leave it to the auditors' judgment to determine whether they are able to obtain sufficient evidence by relying on the work of others.*

23. Does the proposed standard provide an appropriate framework for evaluating the competence and objectivity of the persons performing the testing? Will this framework be sufficient to protect against inappropriate use of the work of others? Will it be too restrictive?

*The second proposed standard expands the potential for auditor reliance on the work of others, which should further reduce the costs of external audits and better align the audit and the management assessment. The proposed standard defines guidelines for competence and objectivity that could expand reliance on work by company employees and contractors other than internal audit. It removes the "principal evidence" requirement and also removes the requirement for original work in testing of controls in the control environment. We believe that these changes will be effective in facilitating greater reliance and lower costs.*

*The proposed standard includes factors to consider in the auditor's evaluation of competence and objectivity to determine the appropriate level of reliance on the work of others. The criteria seem comprehensive, but we have concerns about how the auditors will obtain and document their satisfaction with competence and objectivity based on these somewhat detailed criteria. If the auditor felt compelled to satisfy several of the criteria listed, gathering and reviewing documentation of competence and objectivity could be onerous. We also believe that the focus on organizational status could be interpreted quite restrictively to direct the auditor to rely only on the work of Internal Audit. Many companies have established successful programs of using line testers who have deep knowledge of the processes and controls. In many cases, they are equally or more competent and objective than Internal Audit.*

*We believe that competence and objectivity can be appropriately judged by the auditors in individual company situations without being constrained by factors specified in the proposed standard. Therefore, we would like to see paragraphs 14 and 15 removed from the proposed standard and let the auditor apply his/her judgment in evaluating competence and objectivity.*

24. Has the Board identified the right factors for assessing competence and objectivity? Are there other factors the auditor should consider?

*We believe that competence and objectivity can be appropriately judged by the auditors in individual company situations without being constrained by factors specified in the proposed standard. Therefore, we would like to see paragraphs 14 and 15 removed from the proposed standard and let the auditor apply his/her judgment in evaluating competence and objectivity.*

25. What will be the practical effect of including, as a factor of objectivity, a company's policies addressing compensation arrangements for individuals performing the testing?

*We believe that adding this factor will increase the complexity of documenting objectivity and probably will not add value. The individuals performing the Sarbanes-Oxley compliance testing are typically at a low enough level in the organization that they could not influence their own compensation by the testing results.*

26. Will requiring a walkthrough only for all significant processes reduce the number and detail of the walkthroughs performed without impairing audit quality?

*Yes, changing the requirement to limit walkthroughs to only significant processes should reduce the number and detail of walkthroughs, which are performed at a transaction level under current standards. We believe that walkthroughs should not be required but should be left to the judgment of the auditor.*

27. Is it appropriate for the auditor to use others as direct assistance in performing walkthroughs? Should the proposed standard allow the auditor to more broadly use the work of others in performing walkthroughs?

*The proposed standards still require that the auditor has to perform the walkthroughs. Using others to assist or perform all of part of the walkthroughs should not lessen the quality or rigor. We believe that auditors should have the freedom to rely on the work of others in performing walkthroughs in the same manner that they can rely on the work of others in performing testing. As long as the walkthroughs are properly documented and can be evaluated by the auditors to meet their reliance standards, competent and objective company personnel, including Internal Audit, should be able to perform them.*

28. Does the proposed standard on auditing internal control appropriately describe how auditors should scale the audit for the size and complexity of the company?

*We believe that the proposed standard devotes an appropriate amount of language to acknowledge possible distinctions between small and large company. Interestingly, several of the factors noted in paragraph 12 seem to apply equally to larger companies. (Obviously, some of them do not, such as the likely difference in financial reporting competencies.) We believe that one of the strengths of the proposed standard in general is that it gives good guidance about the outline of a top-down, risk-based approach but then provides much more flexibility for auditor judgment than in the previous standard. That flexibility may be particularly important in working with smaller companies. Because auditor judgment is such a central theme throughout the standard, we do not believe that additional specific language is required to address small company considerations beyond what is already included.*

29. Are there other attributes of smaller, less-complex companies that the auditor should consider when planning or performing the audit?

*There are no other attributes that we feel should be included in the proposed standards.*

30. Are there other differences related to internal control at smaller, less complex companies that the Board should include in the discussion of scaling the audit?

*No*

31. Does the discussion of complexity within the section on scalability inappropriately limit the application of the scalability provisions in the proposed standard?

*No*

32. Are the market capitalization and revenue thresholds described in the proposed standard meaningful measures of the size of a company for purposes of planning and performing an audit of internal control?

*We have no reason to suggest that the thresholds are not reasonable*.

33. Is there other information the auditor should provide the audit committee that would be useful in its pre-approval process for internal control-related services?

*The information in Proposed Rule 3525 seems adequate.*

34. How can the Board structure the effective date so as to best minimize disruption to on-going audits, but make the greater flexibility in the proposed standards available as early as possible? What factors should the Board consider in making this decision?

*For the benefit of calendar year companies, the effective date should be as early as possible in calendar 2007. To minimize disruption and inefficiency, the proposed standard needs to be effective before design evaluations begin for calendar year companies, which would typically begin in the second quarter.*

financial executives international

small public company task force

February 26, 2007

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

Reference: Rulemaking Docket Matter No. 021

Dear Mr. Seymour,

Financial Executives International's ("FEI's") Small Public Company Task Force ("FEI SPCTF") appreciates the opportunity to provide its views on the Public Company Accounting Oversight Board's ("PCAOB's") proposed auditing standard: "An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit Of Financial Statements And Related Other Proposals" (the "proposal") [Rulemaking Docket Matter No. 021].

FEI is a leading international organization of 15,000 members, including Chief Financial Officers, Controllers, Treasurers, Tax Executives and other senior financial executives. FEI SPCTF is a task force 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, from the perspective of small public companies. This document represents the views of FEI SPCTF, and not necessarily those of FEI or its members individually.

FEI's SPCTF notes that a separate comment letter was filed by FEI's Committee on Corporate Reporting ("CCR"). We are aware of no inconsistencies between the two letters, and we join with CCR in commending the PCAOB for its role in proposing guidance to make the audit of internal control over financial reporting more efficient and cost-effective, by focusing on a top-down, risk-based approach directed at items that would be material to the financial statements.

As detailed further in the Attachment hereto, we particularly support the revised definition of materiality – with additional improvements to the definition as outlined below.

While we do believe many of the changes in PCAOB's proposal, being dubbed "AS5", will benefit companies of all sizes, our focus is primarily on the smaller public company. In this regard, FEI's SPCTF strongly support the PCAOB's proposal that the audit of internal control over financial reporting be scalable and consider characteristics of the company such as the company's size and complexity.

## Alignment between PCAOB, SEC Critical to Align Auditors and Management

To achieve the full benefit of maximizing effectiveness of management's and the auditor's role under Sarbanes-Oxley Section 404 as intended by the SEC's and PCAOB's proposed rule revisions, it is critical that the auditors' implementation of the internal control reporting rules under Sarbanes-Oxley Section 404 be aligned with that of management. This alignment requires at the outset a consistent approach in rulemaking between the SEC and PCAOB, followed by implementation by auditors and management consistent with the regulatory framework, and inspected and enforced accordingly by PCAOB inspectors and in reviews of filings by SEC and PCAOB staff. We believe that is the intent of both the SEC and PCAOB in this process.

Although the SEC's proposal is very principles-based, we believe the PCAOB's proposal is too prescriptive in some regards. For example, although the PCAOB permits the auditor to use the work of others, the guidelines for determining which "others" are sufficiently competent and objective are prescriptive.

There are other points in the PCAOB proposal which we believe would benefit by being more closely aligned with the SEC's guidance. We offer certain other suggestions as well. Our objective is to maximize the cost effective use of PCAOB's proposed guidance.

Detailed comments are attached.

FEI's SPCTF greatly appreciates the PCAOB's efforts to make reporting under Sarbanes-Oxley Section 404 more efficient and cost-effective, and we thank you for considering our views.  We would be happy to discuss our comments and recommendations at your convenience. Please feel free to contact Serena Dávila, sdavila@fei.org, Director, Technical Activities, in our FEI's Washington DC office, if you have any questions or wish to discuss.

Sincerely,

Richard D. Brounstein

Richard D. Brounstein, Chairman
Small Public Company Task Force
Financial Executives International

**FEI Small Public Company Task Force**
**ATTACHMENT - Detailed comments**

## Proposed PCAOB Guidance Can Benefit Companies of All Sizes

FEI SPCTF supports the PCAOB in its effort to achieve a more efficient and cost-effective audit of internal control over financial reporting. While there are many aspects of the proposal which can potentially benefit companies of all sizes, we will focus on areas of high interest to a smaller public company, and in particular, a non-accelerated filer preparing to issue its first report under Section 404. Small public companies, with a smaller bottom line to absorb costs of compliance, greatly appreciate the opportunity to benefit from the improved guidance and the lessons learned from larger public companies over the initial two years of implementation. And, with a one-year deferral in AS5 for non-accelerated filers, we believe today's non-accelerated filers will further benefit from such guidance and lessons learned, as noted in our previous comment letters to the SEC.

The following aspects of PCAOB's proposed rule have the potential to greatly assist in making the audit of internal control more efficient and effective.

### Support changing "more than remote" to "reasonably possible"

FEI SPCTF strongly supports the PCAOB's proposed revision to the definition of material weakness which has changed the threshold from "more than remote" to "reasonable possibility." As noted below, however, we believe further amendment to the definition is required to remove the term "and interim" from the definition of material weakness, and to add "in a timely manner" to the end of the definition. See our "suggested improvements" section further below.

### Other changes supported

Among other changes made in PCAOB's proposed standard which FEI SPCTF strongly supports are the emphasis on the top-down approach, permitting use of prior year knowledge, removing the 'large portion' requirement from multi-location engagements, and removing the 'principle evidence' requirement.

We also strongly support the proposal that auditors provide only one opinion on internal control, removing the requirement for a separate opinion on management's assessment.

### Scalability and small companies

FEI's SPCTF also wishes to commend the PCAOB for explicitly addressing small company concerns, such as instructing auditors to evaluate size and complexity of companies when planning and performing internal control audits, and by noting that evaluation should have a pervasive effect on how the auditor conducts the audit.

In particular, instructing auditors that smaller and less complex companies often achieve many of their control objectives through the daily interaction of senior management with company personnel, rather than through formal policies and procedures is an important definitive statement:

> "Routine checks and supervisory activities are often used instead of multiple layers of controls involving numerous personnel performing independent functions."

**Evidence**

FEI SPCTF also strongly supports PCAOB's statement in the proposal that, **"**[t]he auditor should take into account the nature and extent of available audit evidence and the periods of time in which the evidence is obtainable in planning and performing the audit," and that, "[t]he absence of documentation evidencing the operation of a control is not determinative that the control is not operating effectively. In a smaller and less-complex company with less formal documentation, testing controls through inquiry combined with observation or other procedures can, in many cases, provide sufficient evidence about whether the control is effective, even in the absence of documentation."

**Monitoring**

We agree with the PCAOB proposal that a smaller and less-complex company might rely more frequently on monitoring controls performed by senior management to detect misstatements in certain assertions, and that, in these circumstances, the auditor should focus on evaluating those company-level controls. As further discussed in paragraphs 43-44 of the proposal, if a company-level control sufficiently addresses the assessed risk of misstatement, the auditor need not test additional controls relating to that risk.

Also on the subject of monitoring, FEI as a founding member of the Committee of Sponsoring Organizations of the Treadway Commission (COSO) is actively involved in COSO's project to develop guidance on monitoring. We encourage the PCAOB staff observer to be proactive with COSO – so that the project is, as intended, a principles-based, flexible, risk-based approach to monitoring in keeping with the SEC's and PCAOB's principles-based approach. In this way, COSO's guidance would support, and not detract from, the SEC's and PCAOB's intended approach – which we believe is to provide flexibility, scalability, and judgment, and allowing more reasonable expectations on what constitutes evidence generated from management's daily interaction within their business.

**Evaluating the risk of management override and mitigating actions**

The PCAOB's position that the auditor should anticipate that the controls to address the risk of management override at a smaller and less complex company may be different from those at a larger company supports our experience. For example, a smaller and less-complex company may rely on more detailed oversight by the audit committee that focuses on the risk of management override.

The PCAOB's proposal notes that a smaller and less-complex company might have fewer employees in the accounting function, limiting opportunities to segregate duties and leading the company to implement alternative controls to achieve its control objectives. The PCAOB proposal then states, "In such circumstances, the auditor's selection of controls to test should focus on those alternative controls and whether they achieve the control objectives." This is another cost-effective audit approach for smaller public companies.

**Evaluating financial reporting competencies**

When assessing the competence of the personnel responsible for the company's financial reporting and associated controls, we concur that the auditor should take into account both the competence necessary to address the types of transactions and activities the company enters into and the combined competence of company personnel and other parties that assist with functions related to financial reporting. However, see also our comments below about the need for such requirements to be principles based and not overly prescriptive.

**Evaluating information technology ("IT") controls.** We agree with this PCAOB position on IT: A smaller and less complex company with simple business processes and centralized accounting operations often has relatively simple information systems that make greater use of off-the-shelf packaged software without modification. In the areas in which off-the-shelf software is used, the auditor's testing of information technology controls should focus on the application controls built into the pre-packaged software that management relies on to achieve its control objectives and the IT general controls that are important to the effective operation of those application controls.

## SUGGESTED IMPROVEMENTS

FEI SPCTF reiterates our appreciation for the PCAOB'S proposal as outlined on the previous pages. We believe the PCAOB's proposal, in concert with the SEC's proposed management guidance have the potential to help companies and auditors significantly reduce costs, while significantly increasing benefits, of reporting under Sarbanes-Oxley Section 404. However, for these benefits to be achieved, the SEC and PCAOB must work together to ensure alignment of their two proposals.

As detailed below, PCAOB's proposal still appears to be overly prescriptive, and will limit the effectiveness of the SEC's proposal.

Also, certain other improvements to the PCAOB's proposal are recommended below, to avoid unintended consequences and maximize benefit at reasonable cost.

### Definition of Material Weakness Has Improved, But SEC and PCAOB Need to Delete Reference to "And Interim" from Definition

Changing the definition of material weakness from an event which has "more than a remote" possibility of causing a material error to the financial statements, to a control deficiency that poses a "reasonable possibility" of causing a material error will, in our opinion, contribute greatly to removing the extreme granularity of the initial implementation approach.

However, we disagree with the continued inclusion of "and interim" in the definition of material weakness (and by extension significant deficiency) and urge the PCAOB (and SEC) to remove the term "and interim" from the definition of material weakness. There are two reasons why we recommend "and interim" be removed.

First, as a practical matter, it is not clear how "and interim" would be interpreted, resulting in not only a diversity in practice, but also a great deal of resources spent in debates among preparers, auditors, regulators, shareholders and the plaintiff's bar, as to whether something that would be material to a quarter would also be material to the annual period – particularly if the company remedies the matters before the year-end report is issued. Including "and interim" will continue to drive the inefficiencies present in first and second year implementation. Using a year-end reference point, which we believe was the point intended by Congress in the Sarbanes-Oxley Act, would encourage more use of judgment as well, including issues remedied prior to the date the report is issued.

Additional support for our recommendation that SEC and PCAOB remove "and interim" from the definition of materiality for 404 is the recommended definition of material weakness in the November 30, 2006 report of the Committee on Capital Markets Regulation chaired by Glenn Hubbard and John Thornton, which says the definition of material weakness should be with reference to annual financial statements.

The report of the SEC Advisory Committee on Smaller Public Companies (page 54) also recommended the SEC encourage PCAOB to amend AS2 to clarify that materiality should be with respect to annual financial statements, and that conforming treatment be given in SEC, PCAOB and COSO guidance for annual materiality.

**PCAOB Must Conform to SEC Definition By Adding "In a Timely Manner"**

We also note the PCAOB's proposal does not include the full definition of material weakness which is present in the SEC's proposal as it omits the phrase "in a timely manner". That is, a material weakness is a deficiency which would not be prevented or detected "in a timely manner." We strongly agree with the inclusion of the phrase in the SEC proposal, and request the PCAOB conform to the SEC's definition by including the phrase.

**"Elements"**

We note the PCAOB still uses the term significant accounts, and the SEC uses the term "financial statement elements." As we suggested to the SEC in our separate comment letter to them, the SEC and PCAOB should consider, in the spirit of integration, if the two terms should be conformed with the most principles, risk-based definition prevailing.

We also wanted to make the PCAOB aware we have requested that the SEC amend the wording in its proposed guidance to remove the reference to the need to have "all elements" of an internal control framework present, and refer generically to internal control frameworks, since not all frameworks use the term "elements" – (or may, in the future, in a way that would not be conducive to the SEC's requirement to have all elements present). For instance, COSO's July 2006 small business framework specifies the determination of effectiveness of internal control is based on all five components, taken as a whole.

**Predictive ability of internal control assertions and expectation gap**

There is a need to be practical in what internal control testing and assertions can and cannot do. The definition of material weakness implies a predictive element that may not really be practical, may mislead the public, and may erroneously cause companies and auditors to have enforcement action or lawsuits placed on them, due to an expectation (with hindsight) that a misstatement or restatement should have been "predicted" by a finding of an internal control weakness prior to the actual misstatement/restatement. We encourage the SEC and PCAOB to discuss this with constituents.

**Segregation of Duties**

We believe more explicit statements need to be made by the PCAOB in the discussion of "scalability and small companies" in the proposed standards. These particular characteristics do not necessarily equate to a material weakness in internal control. For example, the PCAOB should expressly state that while lack of segregation of duties is a factor to consider, in light of relevant risk factors, and materiality of an item, lack of segregation of duties in and of itself does not necessarily indicate a material weakness in internal control.

The PCAOB could also explicitly state that compensating controls and various forms of monitoring can offset control deficiencies such as lack of segregation of duties.

**SEC, PCAOB Should Go Farther To Explicitly Encourage Integration**

FEI SPCTF believes language should be added to the interpretive guidance to emphasize the audit of internal control over financial reporting was intended by

Congress to be integrated with the audit of financial statements, and that therefore, specified work done for the financial statement audit – and evidence relating thereto – can also be used as evidence for, and to reduce testing relating to, the audit of internal control. Similarly, work performed by management or internal audit to test controls with respect to the financial statements, operations or compliance, can also be used with respect to management's assessment of the effectiveness of internal control.

Additionally, with micro cap and smaller public companies (as defined by the SEC Advisory Committee Report) the integrated audit offers some of the strongest evidence regarding their internal controls over financial reporting. Smaller companies by their very nature are different than larger companies and how one controls such companies to ensure proper financial reporting tends to be more of a substantive analysis of the balance sheet. Tone at the top is relied upon significantly more than detailed process controls that are necessary to pull together financial statements of larger, complex organizations.

**Assessment of "competence" and "objectivity" must be principles based**
To achieve the SEC's and PCAOB's objective of making the internal control assessment process more efficient and effective, it is critical that the PCAOB's rules, including the proposed AS5 standard (replacing AS2) and the PCAOB's proposed standard on use of work of others, support this objective.

FEI SPCTF believes the language in the proposals are too prescriptive in suggesting how competence may be measured, and that the PCAOB guidance could be revised, with concurring language in the SEC's proposed guidance, to provide a more principles-based approach to judging competence.

For example, it is normal business practice at companies small and large to use employees that do not hold certifications of any kind in various parts of their financial reporting and internal control process. Lack of a certification should not hinder a judgment of competence. Also, employees working in accounting departments and in internal control, particularly at smaller companies, may not necessarily have degrees in accounting. This also should not necessarily result in a decision that a particular person lacks the competence to perform the specific job they have been assigned, taking into account training they have received.

Similarly, it would be easy for some auditors and others to presume a lack of objectivity by anyone employed by a company with respect to that company. As a practical matter, and in accordance with longstanding practice, companies routinely have self-assessment and self-monitoring in place, by internal audit, management and employees. It would be helpful for PCAOB to provide an example where a company uses self-assessment by management and the results of that work constitute sufficient evidence for management and the auditor to rely on in a particular area, given the assessment of risk.

**AS5 Appears To Still Lean Toward a Granular/Prescriptive Approach**
Although the PCAOB (and SEC) proposals emphasize a top-down approach, the PCAOB's proposal may still cause auditors to work their way "up" the system to prove what's material in the first place, or to start at the top, but work all the way down in spite of diminished risk and compensating controls.

For example, page 5 of the proposed standard says: "When using a top-down approach, the auditor identifies the controls to test by starting at the top – the financial statements and company-level controls – and linking the financial statement elements and company level controls to:

- significant accounts,
- relevant assertions –[of which there are 6: existence, completeness, valuation, allocation, rights & obligations, presentation and disclosure]
- significant processes
- major classes of transactions (pg A1-16)

We urge the PCAOB to consider if the objective of efficiency and effectiveness with respect to items that could materially affect the financial statements will be achieved by the level of granularity and prescriptiveness in the standard as proposed, which breaks down significant accounts into smaller component levels. There is still a concern there will be a very detailed level checklist approach resulting from the above requirements.

**Documentation**

PCAOB should include explicit guidance that the auditor's documentation needs should not dictate management's documentation needs, and that the auditor should be flexible in considering SEC's guidance as it applies to management, when the auditor exercises his or her own judgment, in applying auditing standards such as the proposed standard.

PCAOB also should explicitly permit use of work performed for substantive audit to be used for the internal control audit. Also, PCAOB should conform to SEC's permission of use of evidence that naturally occurs though management's daily interaction with business.

**The Key Will be in the Implementation**

Even with the principles based approach being advocated in the SEC's and PCAOB's proposals, the key will be in the implementation and interpretation, especially by the larger accounting firms, who invariably become the drivers of best practice. There appears to be a cultural predisposition for some of the accounting firms to revert to a check list and prescriptive approach as a means of implementation, even if the guidance by the SEC and the PCAOB is principles based. This could be because a checklist driven approach may be viewed by some as providing better protection for auditors against legal liability, although check-lists may be mechanically applied with limited relevance.

We believe that for a principles based system to "walk the talk" - in real-life implementation of the standards – the PCAOB inspection process will need to accept reasonable judgments of auditors, and that PCAOB and SEC inspection and enforcement actions will need to allow for a reasonable range of judgment and flexibility in accordance with the principles based standards.

To avoid the bottoms up, mechanistic approach articulated in the control framework jointly issued by nine audit firms - cited in the PCAOB's 4010 report on implementation of AS2 published in November, 2005 as containing "statistical precision suggested by … terms [that] may have driven auditors' decision making process unduly toward simplistic quantitative thresholds and away from the qualitative evaluation that may have been necessary in the circumstances," it is important that the SEC and PCAOB monitor developments that may lead to a repeat of this phenomena.

Thus, it would be helpful if the SEC and PCAOB could avoid encouraging any such private sector framework – including by audit firms, COSO or others - from being issued prematurely or in a way that undermines the principles based approach present in the

SEC’s and PCAOB’s proposals. Ideally, any supplemental guidance that is developed should be the result of due process which involves input from industry as well as the external audit firms.