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The new PCAOB audit standard fails to adequately consider the critical importance of top-level company-wide ethical and compliance control systems to the effectiveness of internal control over financial reporting (ICFR). Failure to emphasize the seven factors set forth in the COSO 2006 guidance on ICFR and omitting discussion of the importance of the effectiveness of audit committee oversight and the professionalism of the internal audit activity indicates that significant revision to the Standard is required.

Additional commentary below is based on my article "404 Guidance: Real Change or Just Window Dressing" which appeared in the February 2007 issue of Strategic Finance magazine.

Emphasizing its earlier guidance on internal control, COSO presented new insights designed to facilitate internal control evaluation. COSO's *Internal Control over Financial Reporting* sets forth seven principles involving the control environment out of a total of 20. The control environment remains only one – albeit the most important – of the five internal control components that must be effective so that an organization's internal control as a whole can be considered effective. The seven new COSO principles that affect the control environment are:

1. **Integrity and Ethical Values** – Sound integrity and ethical values, particularly of top management, are developed and understood and set the standard of conduct for financial reporting.
2. **Board of Directors –** The board of directors understands and exercises oversight responsibility related to financial reporting and related internal control.
3. **Management's Philosophy and Operating Style** – Management's philosophy and operating style support achieving effective internal control over financial reporting.
4. **Organizational Structure –** The company's organizational structure supports effective internal control over financial reporting.
5. **Financial Reporting Competencies –** The company retains individuals competent in financial reporting and related oversight roles.
6. **Authority and Responsibility** – Management and employees are assigned appropriate levels of authority and responsibility to facilitate effective internal control over financial reporting.
7. **Human Resources –** Human resource policies and practices are designed and implemented to facilitate effective internal control over financial reporting.

The PCAOB's proposed standard fails to emphasize the importance of the control environment – including integrity and ethical values – to effective internal control. Although the PCAOB release notes that the proposals are "designed primarily to focus the audit on the matters most important to internal control," this is stated to be "directing the auditor's testing to the most important controls" over transactions and not to the control environment or other company-wide controls.

While intending to focus the external auditor's attention on matters most important to internal controls, the PCAOB's standard, in fact, concentrates primarily on testing details of routine transactions. The focus on specific financial statement assertions, even while considering company-level controls, is evident: "In a top-down approach, if company-level controls are strong and *link directly to the process-level controls* (emphasis added) . . . the auditor will likely be able to reduce the testing of controls at the process level." This statement seems to contradict the PCAOB's public stance of emphasizing reliance on company-level controls. Despite the promised reduction in detailed testing of routine transactions, the new Standard seems to revert back to the old emphasis of testing transaction process controls from a bottom-up perspective.

Paragraph 19 of the new Standard states that the external auditor "must evaluate the control environment at the company." Five general steps the auditor should take in making this evaluation are listed. This requirement is in the section of the Standard involving identification of controls the external auditor should document and later test rather and not in the section prescribing control testing methods.

Concerning testing of the design of controls, paragraph 48 of the draft Standard notes that "the auditor ordinarily performs procedures sufficient to evaluate design effectiveness through the performance of the walkthrough." The major objective of a walkthrough is to "trace a transaction from origination through the company's information system until it is recorded in the company's financial reports." Thus, the prescriptive nature of the new Standard contemplates little if any testing of a company's design of company-level controls, including the control environment.

Concerning the testing of operational effectiveness of internal controls, paragraph 49 of the draft Standard notes that "the auditor should test the operating effectiveness of a control by determining whether the control is operating a designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively." It appears that the new Standard contemplates most testing of controls will involve only routine transaction processes and not the promised top-down approach of company-wide controls.

Paragraph 55 of the PCAOB draft Standard describes the nature of tests of controls. It notes that "Walkthroughs ordinarily consist of some combination" of inquiry, observation, inspection of relevant documentation, and reperformance of a control. Again, this guidance fails to require auditors to use techniques designed to ascertain the state of the ethical climate in an organization or other elements of the control environment. The Standard should suggest use of interviews, employee surveys, the presence and effectiveness of help/hot lines, reports from a properly resourced, independent, and competent internal auditing activity, and evaluation of the quality of oversight provided by the audit committee of the board of directors.

It is true that paragraph 79 of the draft Standard does note that an ineffective control environment is a strong indicator that a material weakness in internal control does exist. However, only two circumstances are cited as examples:

- Identification of fraud of any magnitude on the part of senior management
- Significant deficiencies that have been communicated to management and the audit committee and remain uncorrected after some reasonable period of time.

Other strong indicators of a material weakness are listed, but they aren't linked to the control environment, the most important aspect of internal control. These indicators also do not focus on the significance of ethics and compliance systems.

Respectfully submitted,

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