THE FINANCIAL SERVICES ROUNDTABLE

Impacting Policy. Impacting People.

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February 26, 2007

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

Re: Docket Matter No. 021

Dear Sir or Madam:

The Financial Services Roundtable[1] appreciates this opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB") proposed Auditing Standard regarding internal controls[2] and the use of the work of others when conducting an audit.[3] These standards will supersede the PCAOB's current Auditing Standard No. 2.

As the PCAOB has recognized, Auditing Standard No. 2 has been subject to extensive criticism as being overly prescriptive and inefficient. The Roundtable commends the Board for responding to these concerns by conducting an extensive review and evaluation of this standard, and proposing new standards that address many of the concerns with the existing standard. The new standards were promulgated with the laudable goals of making the audit more risk focused by authorizing a "top-down" approach in which auditor attention is directed to the most significant internal control matters. The new standards also seek to enhance the auditing process through the elimination of unnecessary procedures, permitting the auditor to consider and use the work of others, and tailor the audit appropriately for smaller companies. The proposal also clarifies that the determination to review controls at a branch or other remote office should be based on the risk posed by activities in that location, and should consider the ability of centralized controls to protect against that risk. The Roundtable agrees that these are all important and necessary goals, and recognizes that the new standards make some significant changes in furtherance of these aims. However, as we explain below, the Roundtable believes that considerable improvement in the auditing standards can still be made, and that without these additional changes the proposed standards falls short of the reforms necessary for our member companies' economic health and the protection of investors.

1. Need to Further Enhance Top-Down Risk Based Approach

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[1] Insert.

[2] "An Audit of Internal Control over Financial Reporting that Is Integrated with An Audit of Financial Statements."

[3] "Considering and Using the Work of Others in an Audit."

The introductory materials accompanying the proposed new Auditing Standard indicate that one of the primary goals of the proposal is to encourage independent auditors to take a top-down risk based approach to the audit requirement. However, the text of the proposed new Auditing Standard is still quite prescriptive and process oriented. The detailed instructions in the standard should be replaced with an approach similar to that taken by the Securities and Exchange Commission ("SEC") in its proposed interpretive guidance to management, which explains the key principles and important concepts but allows for considerable flexibility in the methods that management may use to evaluate a company's internal controls over financial reporting. Furthermore, it would be extremely beneficial if the auditor determination of the controls that pose the greatest risks for a material misstatement in financial reports is required to be done in consultation with the company's management and should be consistent with industry norms.

2. <u>Goal of the Audit Should Be Clarified</u>

The proposal states that in order to express an opinion on a company's internal controls over financial reporting, the auditor must plan and perform the audit to obtain reasonable assurance about whether "material weaknesses" in the internal controls exist.

As a preliminary matter, the Roundtable has a fundamental issue with the conclusion that the auditor must independently test internal controls. Section 404 requires the auditor to attest to and report on *management's* assessment of internal controls. Section 103 requires the SEC to promulgate regulations that, among other things, require the auditor to describe the scope of the auditor's testing of internal controls of the issuer, *as required by Section 404*. Taken together, we believe that the focus of the audit should be on an evaluation of management's assessment, and the statute does not envision an independent and second test of internal controls by the outsider auditor.

Second, we note that the proposed Audit Standard defines a "material weakness" as a "control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a material misstatement of the company's ... financial statements will not be prevented or detected." A "reasonable possibility" exists "when the likelihood of the event is either 'reasonably possible or probable.'" This definition of material weakness is highly confusing, and could be interpreted to require the finding that there is "no reasonable possibility that a material misstatement in a financial report will be made or go undetected." That is an extremely high standard to meet, and is inconsistent with both the PCAOB's own position on the role of the auditor and the SEC's guidance to management.

The PCAOB proposed Professional Practice standard[4] explains that an audit report cannot provide "absolute assurance" due to the nature of audit evidence and the possibility of fraud. Rather, the exercise of due professional care allows the auditor to obtain "*reasonable assurance*" whether any material weakness exists. Moreover, the PCAOB proposed model report of audit suggests that the report explains that "A company's internal control over financial

[4] PCAOB Release 2006-007, Appendix 4.

reporting is a process designed to provide *reasonable assurance* regarding the reliability of financial reporting....”[5]

We also note that the SEC’s proposed guidance for management explains that management is required to assess whether the company’s controls is effective in providing *reasonable assurance* regarding the reliability of financial reporting. The SEC proposal states that “reasonable assurance” does not mean absolute assurance and that internal controls cannot prevent or detect all misstatements.[6]

We urge the PCAOB to amend its proposed Auditing Standard to reflect the fact that internal controls can only provide “reasonable assurance” that the financial reports do not contain material misstatements, and that the audit is not expected to determine with absolute certainty the adequacy of internal controls.

The Roundtable also believes that it would be highly beneficial for the Auditing Standard to include a statement similar to the SEC’s Policy Statement issued in connection with the Foreign Corrupt Practices Act (“FCPA”). The FCPA includes a statutory mandate that, like Section 404, requires a company to have internal controls that provide “reasonable assurance” that financial records are accurate. The SEC issued a policy statement regarding compliance with this FCPA requirement that proved to be very useful in explaining the proper implementation. The policy statement included these instructions:

> *The test of the internal control system is whether, taken as a whole, it reasonably meets the statute’s specified objectives.*
>
> *Reasonableness, as a standard, includes a consideration of feasibility. One measure of reasonableness of a system relates to whether the expected benefits from improving it would be significantly greater than the anticipated costs of doing so. Thousands of dollars should not be spent conserving hundreds.*
>
> *There is an almost infinite variety of control devices which could be utilized in a particular business environment. Thus, considerable deference should be afforded to the company’s reasonable business judgments in this area. The selection and implementation of particular control procedures, so long as they are reasonable under the circumstances, remain management’s prerogatives and responsibilities.*
>
> *The accounting provisions principal objective is to reach knowing or reckless conduct, not inadvertent conduct.*
>
> *Corporate management and the board have important roles to play in monitoring and evaluating the adequacy of internal controls, but not involvement in the minutia or recording and accounting for every transaction.*

[5] PCAOB Release 2006-007 at ¶ 96.

[6] 71 Fed. Reg. at 77639 (Dec. 27, 2006).

The inclusion of a similar statement in the Audit Standard would likewise be very helpful in providing auditor guidance as to the appropriate method of implementing the analogous statutory provisions in Section 404.

3. Standard Should Be Focused On Material Weaknesses

The proposed standard explains that the auditor is not required to examine for control deficiencies that do not constitute "material weaknesses."[7] However, the proposal goes on at considerable length and with considerable detail to encourage auditors to look at controls that relate to potential misstatements that do not rise to the level of being considered material. These deficiencies are labeled "significant control deficiencies," but in fact, by definition, they relate to non-material matters. The overall effect is that the auditor will feel compelled to devote considerable time and resources to the review and audit of controls over matters that are not material to the financial reports, thus undermining one of the main goals of the proposal.

In this regard, we also note that the SEC's proposed management guidance states that management should identify "only those controls that are needed to adequately address the risk of a material misstatement."[8] A similar approach should apply for the audit. We, therefore, suggest that the Audit Standard be amended to provide that the auditor should identify and test only those controls that are needed to adequately address the risk of a material misstatement.

4. Work Performed By Others

We support the increased liberalization in permitting the independent auditor to consider and use the work of others. We would hope that the standard could provide more encouragement for this practice. We also urge that auditors should be able to utilize examinations conducted by Federal and State regulatory agencies, such as by the bank examinations conducted by the Federal Reserve, Federal Deposit Insurance Corporation or Comptroller of the Currency, or relevant insurance examiner. Further, we suggest that the Audit Standard encourage the outside auditor to work with management's internal auditor on determining the controls to be tested and the scope of the work, and utilize the work of the internal auditors to minimize repetitive testing. Management should be allowed to communicate openly with the outside auditor on all aspects of the audit.

5. Rotation, Sampling and Consideration of Prior Year's Work

The proposed standard does not permit rotation of audits, sampling or random testing. We strongly urge that these techniques not only be permitted but encouraged, especially after the first initial full scope audit. In this regard we note that the SEC's proposed management guidance states that after the first management assessment, for most companies the amount of

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[7] A "material weakness" is defined as a control deficiency, or combination of control deficiencies, such that there is a reasonably possibility that a material misstatement of the company's financial statements will not be prevented or detected.

[8] 71 Fed. Reg. at 77642 (Dec. 27, 2006).

effort in future years will be significantly less because management should focus on *changes* in risks and controls rather than identification of all financial reporting risks and related controls.[9] The guidance also states that in each subsequent year the evidence necessary to support the assessment will only need to be updated, not re-created. We suggest that, as a minimum, the PCAOB amend the proposed Auditing Standard to reflect the SEC's position on reliance on prior years' work, and the need to focus the audit on changes and updating. Further, the PCAOB should also specifically authorize sampling and random testing for low risk companies that have had a successful full scope audit in prior years.

6. Service Organizations

Under the proposal, a company that provides to the subject company services that are incorporated into the subject company's internal controls information systems will itself be subject to an internal control review. In other words, the internal control audit of the subject company will include a review of the internal controls of the service company. The subject company's auditor may, but is not required to, rely on an independent audit of the internal controls of the service company. We would propose that the auditor should be required to rely on the independent audit of the internal controls of the service company, unless there is reason to believe that such audit is no longer timely or accurate.

7. Scope

The Roundtable supports the proposed standard's requirement to determine the scope of the audit of internal controls based on the risk of a material misstatement associated with the location or business unit, and not simply require the inclusion of all operating locations or units.

8. Auditor Competition

The Roundtable supports enhanced competition in the audit industry. Currently, the number of accounting firms that have the capability of auditing a large sophisticated company is very limited. If one of these firms is also providing other services for the company, a conflict will often arises that prevents the same firm from auditing that company's internal controls, thus further limiting competition. We urge the PCAOB to take all reasonable steps to increase the number of qualified accounting firms and to eliminate the need to disqualify a firm due to a de minimis conflict. In this regard the PCAOB should develop new and more realistic conflict of interest standards that reflect the need to increase competition. The PCAOB should also encourage smaller accounting firms to take innovative measures, such as forming joint ventures that would allow these smaller firms to compete for large company business.

9. Criminal Liability

The Roundtable believes that the provisions in the statute that impose potential criminal liability for knowingly filing a false report or certification has caused a level of concern in both the accounting profession and among company management that is counterproductive to efficient

[9] 71 Fed. Reg. at 77641 (Dec. 27, 2006).

and reasonable audits. As a result, some auditors have adopted a zero tolerance policy that is based more on the threat of criminal prosecution than on good accounting practices. Likewise, companies are finding it harder to attract and retain managers who are concerned with potential liability for making good faith errors. Whether or not the statute actually creates such liability is not the point. The problem is that the statute creates a perception that such liability exists. We urge the PCAOB to use the Accounting Standard to emphasize to the accounting industry that there is no criminal liability for good faith errors, and to encourage Congress to clarify that the statutory criminal sanction does not require perfection.

Conclusion

The proposed Auditing Standard makes many improvements over Auditing Standard No. 2. However, significant modifications to the proposal should be made to effectuate the goal of the PCAOB to reduce unnecessary costs and burdens and to encourage auditors to use a top-down risk based approach. We hope that the PCAOB will consider the changes recommended in the letter in order to make the Auditing Standard more consistent with the SEC's proposed guidance and to take other steps to make the audit less costly and more useful to both the audited company and the public. For any additional information, please feel free to contact me at 202-589-2410 or Irving Daniels at 202-589-2417.

Best regards,

Steve

Steve Bartlett
President and CEO