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February 26, 2007

BY ELECTRONIC MAIL

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

Re: Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting that is Integrated With an Audit of Financial Statements and Related Other Proposals (PCAOB Release No. 2006-007)(Rulemaking Docket Matter No. 021)

Ladies and Gentlemen:

We are submitting this letter in response to the request of the Public Company Accounting Oversight Board (the "PCAOB") for comment regarding the PCAOB's proposed auditing standard entitled "An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements" (the "Proposed Standard") and related other proposals.[1] The Proposed Standard would supersede the PCAOB's Auditing Standard No. 2 ("AS No. 2").

We welcome the concurrent efforts of the PCAOB and the Securities and Exchange Commission (the "Commission")[2] to improve the process of evaluating and auditing internal control over financial reporting ("ICFR"). We agree with the PCAOB's view that the benefits of an audit of ICFR under AS No. 2 have come with significant cost, and commend the PCAOB for its efforts to re-evaluate the significant aspects of AS No. 2 to determine

1 PCAOB Release No. 2006-07 (December 19, 2006) (the "PCAOB Release").
2 SEC Release No. 33-8762; 34-54976 (December 13, 2006) (the "SEC Release").

whether they encourage auditors to perform procedures that are not necessary to achieve the intended benefits. If properly implemented, we believe the Proposed Standard will help make audits of ICFR more efficient and cost-effective.

We believe the Proposed Standard could be meaningfully improved by adopting the suggestions set forth below.

1. The PCAOB should adopt a "reasonable likelihood" threshold for the definitions of material weakness and significant deficiency.

We agree with the PCAOB's observation that the current probability threshold used in the definitions of material weakness and significant deficiency too often has led issuers and auditors to calibrate their testing of controls and evaluation of control deficiencies at an unduly low level.

We disagree, however, with the proposed solution set forth in the PCAOB Release. It is difficult to see how replacing the term "more than remote likelihood" with its synonym under SFAS No. 5 -- "reasonable possibility" – will have a meaningful impact on issuer or auditor behavior.

The problem with the current probability threshold is not that it has been misunderstood – the problem is that the threshold is too low. The current definition too often results in the identification of material weaknesses that are not viewed by investors as matters of concern. By setting the threshold too low, the current standard leads issuers and their auditors to expend significant resources to achieve a confidence level that is higher than investors expect or need, particularly in light of the considerable protection already afforded by the audit of the financial statements. Moreover, by multiplying the number of material weaknesses triggered by low-probability risks, the existing definition makes it more difficult for investors to identify the higher-probability material weaknesses that are better deserving of attention.

To address these concerns, we recommend that the PCAOB and the Commission adopt the "reasonably likely" threshold the Commission has used in connection with management's discussion and analysis of financial condition and results of operations. We believe adopting this standard would have several advantages.

- First, like the SFAS No. 5 standard that underlies the current definition, the "reasonably likely" standard is well understood by both issuers and auditors. This should help make the standard easy to understand and apply.

- Second, because it is meaningfully higher than the "more than remote" standard, a "reasonably likely" threshold will have a better chance of focusing the evaluation and audit on the deficiencies that are likely to be of greatest concern to investors.

- Third, by reducing the incidence of reports of material weaknesses involving low-probability risks, the proposed definition will help ensure that more important disclosures concerning high-probability risks receive the attention they deserve.[3]

2. The PCAOB should revise or eliminate the list of strong indicators of a material weakness.

We share the PCAOB's concern that the existing list of strong indicators of a material weakness in AS No. 2 has proved to be too rigid a framework. While the list is phrased only as a presumption, in practice experience has shown that auditors faced with circumstances on the list are rarely willing to conclude that a material weakness is not present. Although we welcome the PCAOB's decision to remove the provision providing that these matters are always at least significant deficiencies, we believe that unless the PCAOB addresses the core presumption embodied by the list, auditors will continue to be reluctant to exercise their judgment to determine that a material weakness is not present when a listed circumstance arises.

On balance, we believe the best solution would be to eliminate the list altogether. Although the factors identified by the PCAOB are worthy of consideration and will in many cases coincide with the presence of a material weakness, this is not always the case. Attaching a presumption to these items gives them undue prominence and hampers the context-sensitive evaluation of facts and circumstances that should guide any determination that a material weakness is present.

If the list is retained, we suggest that the PCAOB revise the introductory clause of Paragraph 79 to state that the listed items "may" indicate the presence of a material weakness, but that an auditor must evaluate the specific facts and circumstances relating thereto and may conclude, in its professional judgment, that no material weakness exists. We further suggest that to the extent the two are inconsistent, the PCAOB's list should be conformed to the shorter list in the SEC's proposed interpretive guidance. We also suggest that guidance be provided to highlight factors relevant to each item on the list that may suggest that a material weakness is not present. In particular:

- Although the identification of fraud of any magnitude on the part of senior management is a possible indicator of an ineffective control environment, the Proposed Standard should expressly remind the auditor of its duty to evaluate the particular facts and circumstances and should acknowledge that not every fraud involving senior management will result in a material weakness. For example, if the fraud was detected or prevented by the issuer's internal controls and the matter was dealt with appropriately, the

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[3] Similar concerns led the Commission to adopt a "reasonably likely" standard when adopting Item 303(a)(4) of Regulation S-K concerning disclosure of off-balance sheet arrangements. There, the Commission initially proposed a standard equivalent to "more than remote" but in response to comments changed it to "reasonably likely" to reduce "the possibility that investors will be overwhelmed by voluminous disclosure of insignificant and possibly unnecessarily speculative information." <u>See</u> SEC Release No. 33-8182 (January 28, 2003).

facts and circumstances may suggest strong controls rather than a material weakness. Other factors that may be relevant, particularly where the amounts in question are immaterial, include the nature of any disciplinary action taken by the issuer.

- The indicator relating to restatements of previously-issued financial statements should be revised to note that not all restatements indicate a weakness in internal controls. In particular, the note to this provision should indicate that a restatement that results from a change in interpretation of existing accounting standards by the auditing profession or an applicable standard-setter should be not be considered a restatement that gives rise to a presumptive material weakness.

- An explanatory note should be added to the indicator relating to identification by the auditor of material misstatements in the financial statements in circumstances that indicate that the misstatement would not have been detected by the company's ICFR. In light of the chilling effect the parallel provision in AS No. 2 has had on communications between auditors and their clients in the past, the PCAOB should either include a cross-reference to the guidance in its May 16, 2005 policy statement regarding such communications or include the relevant language in the Proposed Standard itself.

- If the indicator relating to ineffective oversight by the audit committee is retained, we suggest two changes. First, the indicator should be made a sub-bullet under the heading "ineffective control environment" rather than its own stand-alone heading. Second, language should be added to the explanatory note to indicate that the auditor should consider the importance of the audit committee's effectiveness in light of the overall control environment implemented by the company. For example, if a company has a strong culture of compliance and a robust overall system of internal control, the relative importance of the audit committee in detecting or preventing material weaknesses may be less significant than it would be in companies that lack such attributes. Under such facts and circumstances, it may be reasonable for an auditor to conclude no material weakness exists.

- The indicator relating to the internal audit and risk assessment function should be accompanied by language highlighting factors that may be relevant to a decision regarding whether a deficiency in such area is in fact a material weakness. For example, where a company makes a decision to rely more heavily on direct testing in connection with the evaluation and audit of ICFR than on ongoing monitoring, the importance of the internal audit function may be offset by the increased direct testing.

- If the indicator relating to an ineffective compliance function is retained, we suggest that the Proposed Standard include an explanatory note that explains the relevant considerations to be considered in determining whether such function is necessary and whether it is effective.

3. The PCAOB should eliminate or clarify the presumption that the items set forth in Paragraph 78 of the Proposed Standard will ordinarily constitute significant deficiencies.

The list of presumptive significant deficiencies set forth in Paragraph 78 of the Proposed Standard raises concerns similar to those raised by the presumptive list of material weaknesses. Although the items on the list in Paragraph 78 often will result in significant deficiencies, establishing a presumption unwisely shortcuts the analysis and discourages the auditor from applying its professional judgment to perform a context-sensitive evaluation of the particular facts and circumstances. Among other things, singling out these items as presumptive significant deficiencies runs the risk of diminishing the importance of potential compensating controls that may correct for such deficiencies and minimizes the possibility that some control deficiencies within these categories may be less serious than others. On balance, we recommend that Paragraph 78 be deleted. If it is retained, we suggest that the preamble be revised to clearly state that although these factors "may" constitute significant deficiencies, the auditor should use its professional judgment to evaluate the particular facts and circumstances before concluding that a significant deficiency exists.

4. The PCAOB should exempt a foreign private issuer's U.S. GAAP reconciliation from the audit of ICFR.

We agree with the position set forth in footnote 47 of the SEC Release that management of a foreign private issuer should plan and conduct its evaluation of ICFR based on the primary financial statements rather than the reconciliation to U.S. GAAP. In our concurrent comment letter to the Commission regarding the SEC Release, we recommend that the Commission clearly exempt a foreign private issuer's U.S. GAAP reconciliation from management's evaluation of ICFR. For similar reasons, we recommend that the PCAOB exempt the U.S. GAAP reconciliation from the audit of ICFR. Including the U.S. GAAP reconciliation in the ICFR evaluation and audit process would significantly increase the burdens borne by foreign private issuers without achieving significant benefits for investors, who rely mainly on the primary financial statements.

5. The PCAOB should eliminate or substantially revise the requirement that an auditor assess whether the company has taken action to reduce or mitigate the incentives and pressures on management that might provide a reason to misstate the company's financial statements.

We share the PCAOB's view that the auditor should take note of the presence of incentives to misstate the financial statements. We are concerned, however, that in the absence of explicit guidance to the contrary, some auditors may take the language in Paragraph 20 as an invitation to intervene in the structuring of incentive compensation for executives, a matter beyond their expertise. We accordingly recommend that the PCAOB delete this provision. If it is retained, we urge the PCAOB to clarify the factors (e.g., strong antifraud programs, controls to prevent management override) that can constitute effective means of reducing or mitigating the pressures from incentive compensation. The PCAOB should also acknowledge that incentive compensation structures serve many beneficial purposes, including aligning the interests of management with those of the shareholders, and that the mere presence of an incentive compensation structure, without more, would not suggest an ineffective control environment.

6. The PCAOB should clarify the relevance of account balance materiality to an audit of ICFR.

We welcome the PCAOB's decision not to incorporate into the Proposed Standard the language in paragraphs 22-23 of AS No. 2. Those paragraphs indicated that an audit of ICFR requires an auditor to apply the concept of materiality at both the financial statement level and at the individual account balance level. In our view, this language in AS No. 2 all too often has led auditors to focus on potential misstatements that – although material at the account balance level – were far from material to the financial statements as a whole. We encourage the PCAOB to explicitly state that the relevant materiality standard for conducting audits of ICFR and evaluating deficiencies is materiality to the financial statements as a whole.

7. Paragraph 90 should be revised to acknowledge that an issuer may furnish the auditor's written audit committee communications to underwriters and others conducting a due diligence investigation.

Paragraph 90 should be revised to acknowledge that an issuer may legitimately furnish copies of the auditor's written communications to the audit committee regarding ICFR to underwriters and other parties performing due diligence investigations of the issuer. Absent this clarification, the language in Paragraph 90 could be misinterpreted to suggest that it is inappropriate for an issuer to divulge such communications to underwriters or other parties that conduct due diligence investigations. Given the importance of ICFR issues to the due diligence inquiry, we suggest that the PCAOB explicitly acknowledge that furnishing the information under such circumstances is not only permitted but appropriate. To ensure that such communications are shared in a way that guards against the potential for misinterpretation or misunderstanding of the limited degree of assurance associated with such communications, we recommend that the PCAOB suggest or permit an appropriate disclaimer or legend to be used when these communications are furnished by the issuer to third parties in this context.

8. The PCAOB should clarify the factors an auditor should consider in determining which company-level controls are important enough to require testing.

Paragraph 17 of the Proposed Standard instructs an auditor to test those company-level controls that are "important" to the auditor's conclusion about whether the company has effective ICFR. We suggest that the PCAOB add an explanatory note to clarify the factors an auditor should consider when making this determination.

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We appreciate this opportunity to provide the PCAOB with our thoughts on the Proposed Standard. We would be pleased to respond to any inquires regarding this letter or our views on the Proposed Standard more generally. Please contact Leslie N. Silverman, Nicolas Grabar or Mark A. Adams at (212) 225-2000.

Very truly yours,

CLEARY GOTTLIEB STEEN & HAMILTON LLP

cc: Public Company Accounting Oversight Board
Hon. Mark W. Olson, Chairman
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