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Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 20006-2803

**Re: PCAOB Rulemaking Docket Matter No. 021
Proposed Auditing Standard – An Audit of Internal Control Over Financial
Reporting That Is Integrated with an Audit of Financial Statements and
Related Other Proposals**

Ladies and Gentlemen:

This letter is submitted on behalf of the Committees on Federal Regulation of Securities and Law and Accounting (the “Committees”) of the Section of Business Law of the American Bar Association in response to the request for comments by the Public Company Accounting Oversight Board (the “Board”) in its December 19, 2006 proposal referenced above (the “Proposal”).

The comments expressed in this letter represent the views of the Committees only and have not been approved by the American Bar Association’s House of Delegates or Board of Governors and therefore do not represent the official position of the American Bar Association (the “ABA”). In addition, this letter does not represent the official position of the ABA Section of Business Law, nor does it necessarily reflect the views of all members of the Committees.

Summary of Comments

We commend the significant efforts by the Board to increase the efficiency and effectiveness of the audit of internal control over financial reporting (“ICFR”) through the

proposal of a new auditing standard and related standards. These standards are designed to focus the audit on the matters that are the most important to internal control, eliminate unnecessary procedures, provide guidance relating to the audit of smaller companies, and simplify the auditing standard. We particularly agree with the Board's acknowledgement that the audit of ICFR does not require auditors to search for deficiencies that are less severe than material weaknesses and with the proposals to remove the requirement that the auditors evaluate management's evaluation process, to permit the auditors to consider knowledge obtained in previous audits, to eliminate the requirement that the auditor's work provide the "principal evidence" for the auditor's opinion, to permit the reduction of the scope of the audit of multiple locations, when appropriate, and to recalibrate the walkthrough. In addition, we believe that the proposed auditing standard is significantly easier to read and understand than Auditing Standard No. 2 and should enhance the focus of the audit.

We believe, however, that changes in the following areas would further reduce unnecessary audit work and enhance an understanding of the PCAOB's requirements:

- (1) the definitions of material weakness, significant deficiency, significant account, and significant;
- (2) the assessment of the materiality of the potential impact of risks on the financial statements;
- (3) the audit of a "smaller company";
- (4) the role of the audit committee;
- (5) the assessment of the period-end financial reporting process;
- (6) the integration of the audit of internal control over financial reporting and the audit of financial statements; and
- (7) the assessment of the objectivity of others.

Definitions

We believe that the proposed definitions of material weakness, significant deficiency, relevant assertion, significant account and major classes of transactions in the Proposal may not achieve the objective of reducing unnecessary work.

"Reasonably possible" standard. We believe that the current "more than remote likelihood" standard is too low a probability standard. We understand that the proposed change in the definitions of material weakness and significant deficiency to replace the term "more than remote likelihood" with the term "reasonably possible" is not intended to change the probability standard but to articulate the standard in a clearer manner. We believe that the proposal is not helpful because it would not change the probability standard. Accountants have interpreted the

terms remote, reasonably possible and probable, as used in Financial Accounting Standards No. 5, "Accounting for Contingencies" ("SFAS 5"), as levels of probability that are contiguous, that is, once an event is more probable than remote, it is reasonably possible.¹ The event becomes probable when it is more probable than reasonably possible. This interpretation of reasonably possible leads to events being reasonably possible at a probability level of substantially less than 50%. In fact, we have been told that some accountants take the position that reasonable possibility is triggered at a probability level of as low as 25%. We believe that such a level of probability is too low for this purpose.

We base this position on our belief that companies are disclosing as "material weaknesses" control deficiencies that are not in any conventional understanding of the term material to their companies based on their reasonable and good faith interpretation of the current definition. This belief, in turn, is based on our observation of the market's reaction to the frequent disclosures of "material weaknesses" that have occurred since the requirement to report on the effectiveness of disclosure controls and procedures and ICFR. In many cases, these disclosures have had very limited, if any, impact on the market price of the company's shares. We believe that this is attributable to a market perception that material weakness disclosures are not meaningful because, as currently cast, the net sweeps in items that are not truly important to an investor in evaluating the reliability of the financial statements or the effectiveness of the company's ICFR.

While we commend the effort of the Board and the Securities and Exchange Commission (the "SEC") to use clearer terminology, we believe that the terminology employed in the proposed formulation of the term "material weakness" is sufficiently ambiguous so as to continue to result in the overly conservative applications that these proposals seek to address. We note that the Financial Accounting Standards Board ("FASB") determined to use a different standard from those defined in SFAS 5 in its Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109" ("FIN 48"). In determining to use a more likely than not standard, which it defined as "a likelihood of more than 50 percent"², the FASB observed that "the confidence level expressed by probable is not consistently understood and applied by constituents."³ We believe that the confidence level expressed by "reasonable possibility" will similarly not be consistently understood and applied.

¹ SFAS 5, paragraph 1(b)(ii) defines a range of probability from "probable" to "remote." Between "probable" and "remote" on the range is "reasonably possible," which is defined as "the chance of the future event or events occurring is more than remote but less than likely."

² FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109," at paragraph 6.

³ Id., at paragraph B32.

Accordingly, we suggest that the Board (i) identify with a higher degree of precision than is contained in the Proposal the level of likelihood that should lead to a conclusion that a control deficiency would cause a misstatement of the financial statements that is “material” and, in doing so, (ii) identify a level of likelihood that is higher than that underlying the synonymous phrases “more than remote likelihood” and “reasonable possibility.” As noted under “The Assessment of Materiality” below, we have proposed a definition of “material weakness” that incorporates these suggestions for your consideration.

Interim financials. We also believe that the reference to the impact of the control deficiency on interim financial statements as well as annual financial statements in the proposed definitions of material weakness and significant deficiency may lead to unnecessary work. Since the evaluation of ICFR is as of the end of a fiscal year and in the context of annual financial statements, we question the need for management and the auditors to also assess the impact on interim financial statements. Which interim financial statements would management consider? For a seasonal company, the impact of a control deficiency on the interim financial statements in one quarter may be extremely different from the impact on another quarter. We recommend deletion of the reference to interim financial statements, particularly since it has been suggested that the staff of the SEC needs to develop workable materiality principles applicable to quarterly financial statements.⁴

Assessment of materiality. We recommend that the Board provide guidance for purposes of the definitions of material weakness and significant deficiency as to the assessment of the materiality of the impact of a control deficiency on the company’s financial statements. In this context, as discussed below, we believe that requiring an assessment of the qualitative materiality of the impact of a material weakness on future financial statements, which might be required if SEC Staff Accounting Bulletin No. 99 (“SAB 99”) were to apply to such an assessment, would be extremely difficult and more than likely unproductive. Accordingly, we suggest that the Board make clear that SAB 99 should not be applied by auditors in attesting to management’s assessment of ICFR.

Combination of deficiencies. We believe that the definitions of material weakness and significant deficiency should be revised to clarify the intent of the requirement to consider the

⁴ See, “Remarks Before the 2006 AICPA National Conference on Current SEC and PCAOB Developments,” by Todd E. Hardiman, Associate Chief Accountant, Division of Corporation Finance, SEC (December 12, 2006).

impact of “a combination of control deficiencies.” It seems to us that individual control deficiencies should only be evaluated on a combined basis if they are interdependent or related controls. The mere existence of more than one control deficiency, each of which individually is not considered to lead to a likely material misstatement of financial statements, should not result in the conclusion that there is a material weakness. We note that Section III.B.1., “Evaluation of Control Deficiencies,” of the Proposed Interpretation, “Management’s Report on Internal Control Over Financial Reporting,” issued by the SEC (the “SEC’s Proposed Interpretation”) seems to suggest that control deficiencies would only be combined if they affect the same financial statement account balance, disclosure, relevant assertion, or component of internal control. The Proposal does not have similar language. We recommend that the proposed definitions be revised to provide that individual control deficiencies should be combined for purposes of assessing the impact of the control deficiencies on the financial statements in those instances where the controls are interdependent or interrelated controls.

Definition of “significant.” We agree with the proposal to replace the term “more than inconsequential” with “significant” in the definition of significant deficiency. However, we recommend that the definition of significant be clarified. We do not believe that the definition of “significant” as “less than material yet important enough to merit attention by those responsible for oversight of the company’s financial reporting” is clear enough to be helpful. Perhaps the definition could explain the circumstances when a person with responsibility for the oversight of financial reporting (such as the chief financial officer or the audit committee) would need to give attention to the control deficiency with a view to remediation.

Relevant assertion and significant account. Finally, the definitions of relevant assertion and significant account also use the term “reasonable possibility” and require an assessment of the likelihood that there would be a material misstatement of the financial statements. Our comments above about “reasonable possibility” being too low a standard and the need for clarification as to the judgment of a material misstatement of financial statements applies to these definitions as well.

The Assessment of Materiality

In our view, the most effective way for the Board to reduce the unnecessary costs and scope of the independent registered public accounting firm’s audit is to clarify the meaning of “materiality” for purposes of the auditors’ attestation of ICFR. In our view, this clarification should state expressly that SAB 99 is not relevant to the assessment of materiality in the context of ICFR and should set forth factors that are relevant to the evaluation of ICFR.

SAB 99 articulates the view of the SEC’s staff as to the assessment of the materiality of an error in previously disclosed financial statements. As a disclosure standard, it is inapposite to the evaluation of the impact of control deficiencies on ICFR. SAB 99 requires management to assess the impact of errors not only based on the quantitative impact of the errors on the financial statements, but also on the basis of qualitative factors. Absent clarification, management and auditors will continue to assume that the qualitative factors contemplated by SAB 99 must be considered in evaluating the materiality of the impact of a control deficiency.

We think that requiring auditors to consider SAB 99 in evaluating the possible impact of a control deficiency on the financial statements could lead to excessive work and unnecessary cost, without a corresponding benefit to investors, because of the need to try to predict the impact of qualitative factors as described in SAB 99 that might be important in the future, such as, consensus estimates, bonus levels and other factors typically reviewed in an analysis of materiality under SAB 99. Furthermore, we do not think that qualitative factors like those identified in SAB 99 would be important in assessing prospectively the impact of a risk of a control deficiency.

We agree that the evaluation of the likelihood of a misstatement should take into account the factors identified in the proposed guidance in the third paragraph of Section III.B.1 of the SEC's Proposed Interpretation, such as the nature of the financial statement elements involved, the susceptibility of the related asset or liability to loss or fraud, the subjectivity, complexity or extent of the judgment involved and other factors. These are factors that may affect the amount of a misstatement and therefore are relevant to the effectiveness of ICFR. If the Board intends that such factors be considered by auditors in evaluating the materiality of the impact of the risk on the financial statements, we recommend that the Board clarify that, in evaluating whether a risk may have a quantitatively material impact on the financial statements, auditors should take into account the factors identified in the third paragraph of Section III.B.1 of the SEC's Proposed Interpretation.

Attached as Exhibit A hereto is a recommended revision to the definition of "material weakness" that addresses our comments set forth above for your consideration.

The Audit of a Smaller Company

We are concerned that the definition of smaller company and the guidance with respect to the audit of a smaller company will not provide auditors with enough direction to enable them to reduce the extent of the audit work. In light of the Board's inspection process and the risk of liability to auditors if they fail to identify material weaknesses, we are concerned that auditors will feel that they must conduct as rigorous an audit of a smaller company as of their larger audit clients.

The Role of the Audit Committee

In the Proposal (Page A1-9), the Board states that: "a smaller and less complex company may rely on more detailed oversight by the audit committee that focuses on the risk of management override." While the audit committee of a smaller, less complex company should be aware of the risk of management override, we believe that the Board's statement could lead auditors to inappropriately include an assessment of the effectiveness of the audit committee as part of the process through which they obtain an understanding and evaluate the control environment and monitoring components of ICFR. We are not aware of any support for the proposition that an audit committee of a smaller, less complex company has a more detailed oversight role than the audit committee of a large, complex company, nor are we aware of what

the standards would be for such a "detailed" oversight function. Accordingly, we suggest that the Board delete or modify the statement in the final standard.

The Assessment of the Period-End Financial Reporting Process

The Proposal states that the assessment of the period-end financial reporting process should include the evaluation of procedures used to record adjustments to quarterly financial statements and for drafting quarterly financial statements and inputs, as well as procedures performed and outputs of the processes the company uses to produce its quarterly financial statements. We believe that the focus on quarterly financial statements will require the auditors to expand the scope of the audit of ICFR beyond the ICFR as of the end of the fiscal year, on which the attestation is supposed to focus.

The Integration of the Audit of ICFR and the Financial Statements

Paragraph B6 of the Proposal suggests that auditors will need to do tests of controls in connection with their audit that are different from those tests that they will be required to conduct to express an opinion on ICFR. We do not understand why the integration of the audits of ICFR and the financial statements cannot result in one set of tests of controls for both audits.

The Assessment of the Objectivity of Others

We are concerned that the Proposed Auditing Standard – “Considering and Using the Work of Others in an Audit” may not achieve the Board’s objectives. The standard requires that auditors assess, in determining whether they can rely on others, the company’s “[p]olicies designed to assure that compensation arrangements for individuals performing the work do not adversely affect objectivity and whether the policies are being complied with.” We believe that most companies provide incentive compensation arrangements based on financial measures to a large number of their employees. In our experience, companies do not have policies that would meet the Board’s Proposal. They have codes of conduct and ethical policies, but these codes and policies are not focused on compensation arrangements.

We appreciate the opportunity to provide these comments. Members of the Committees are available to discuss them should the Board or the staff so desire.

For your convenience, a copy of our letter of comment to the SEC on its Proposed Interpretation is attached.

Respectfully submitted,

/s/ Linda L. Griggs

Linda L. Griggs, Chair of the Committee
on Law & Accounting

/s/ Keith F. Higgins

Keith F. Higgins, Chair of the
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Exhibit A: Recommended Definition of Material Weakness

Recommended Definition of Material Weakness

A **material weakness** is a control deficiency that is deficient, or a combination of interdependent or interrelated controls that are deficient, such that there is a greater than 50% chance that the company's annual financial statements will be misstated in a quantitatively material way, based on the consideration of appropriate factors such as:

- the nature of the financial statements elements, or components thereof, involved (e.g., suspense accounts and related party transactions involve greater risk);
- the susceptibility of the related asset or liability to loss or fraud (i.e., greater subjectivity, complexity, or judgment, like that related to an accounting estimate, increases risk);
- the interaction or relationship of the control with other controls (i.e., the interdependence or redundancy of the control); and
- the interaction of the deficiencies (i.e., when evaluating a combination of two or more deficiencies, whether the deficiencies could affect the same financial statement accounts and assertions).

Instruction to definition of material weakness: Since Staff Accounting Bulletin No. 99 is a disclosure standard, it is not relevant to the assessment of materiality in the context of internal control over financial reporting.